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THE THEORY

OF

INTERNATIONAL TRADE

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THE THEORY

OF

INTERNATIONAL TRADE

WITH

SOME OF ITS APPLICATIONS TO ECONOMIC POLICY

BY

C. F. BASTABLE, M.A., LL.D.

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AUTHOR OF 'PUBLIC FINANCE,' 'THE COMMERCE OF NATIONS'

FOURTH EDITION, REVISED

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PREFATORY NOTE TO FOURTH EDITION

SINCE the last edition of this book appeared the subject of International Trade has come into unexpected prominence. In the phraseology lately fashionable it has passed from the domain of "academic discussion" into the position of a "burning question." This change is not altogether favourable to its treatment in a scientific manner. The greater part of the writing in the press and periodical literature is certain to be crude and ill-informed, the product of persons who have not taken the trouble to study the general principles that underlie the more obvious features of foreign commerce. The intrusion of party feeling is a further disturbing influence. Where established principles stand in the way of a particular proposal its supporters will at once declare their disbelief in what they call "abstract theory," though they will readily use any of those principles that can be so distorted as to appear to serve their purpose.

It is, therefore, the more necessary to insist on the indispensableness of a general theory for the correct interpretation of the complicated phenomena of foreign

trade, and also on the connection of that theory with the principles of economics as a whole. Without the assistance of such a theory success is impossible; with its aid a consistent account of the mass of facts, otherwise so perplexing, can be supplied.

The changes in the present edition have been slight, and consist in additional illustrations or notices of criticisms which seemed to require consideration.

C. F. BASTABLE.

TRINITY COLLEGE, DUBLIN,
11*th July* 1903.

NOTE TO THIRD EDITION

THE text has been again revised and some mistakes corrected. In particular, Professor Edgeworth's criticism has led to the removal of a serious error, and one of the statements as to comparative cost has been modified at the suggestion of Professor Marshall. An additional Appendix dealing with some disputed points has been added, and the text has by this means been relieved of some controversial matter unsuitable for ordinary students who may require to use the book.

NOTE TO SECOND EDITION

In this edition the text has been revised throughout, some matter of temporary interest omitted, and the various discussions brought up to date. As the book is specially intended for serious students of economic theory, the principles of the subject are considered, freed as far as possible from unnecessary details. Those who desire to follow the actual course of commercial policy and the several phases of protectionism and free-trade, may be referred to the author's *Commerce of Nations* (Methuen), which supplements, and is supplemented by, the present work.

Very hearty thanks are due to Mr. A. B. Clark, M.A., for his kindly interest manifested by reading the proof-sheets, and furnishing many valuable suggestions and criticisms.

FROM PREFACE TO FIRST EDITION

THE present work is an attempt to restate, in a more complete form, the doctrines of the classical English School on an important and difficult branch of political economy. That school has been severely criticised from several different standpoints, and there need be no hesitation in admitting that the whole body of economic science stands in need of a thorough revision, and, in some of its parts, an entire reconstruction. But it is not, therefore, incumbent on us to throw aside the more solid portions of the older building: it will rather be expedient to utilise all sound material already existing, and, as far as possible, to preserve that continuity of development which is one of the notes of a truly scientific system.

The theory of international trade has, therefore, been selected for exposition as being one of the products of the older political economy which is well worth preserving, and one, moreover, which is peculiarly suited for students, both on account of its intricacies and the logical processes employed, as also by reason of its bearing on the old, but still unclosed, controversy respecting the comparative merits of "protection" and free-trade.

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CHAPTER I

PRELIMINARY—THE GENERAL FEATURES OF INTERNATIONAL TRADE

THE theory of Foreign Trade, with the various applications of that theory, admittedly forms one of the most complicated branches of economics. After all that has been written on the subject, there seems to be a haze over some of its most critical points, and even some difficulty in exactly apprehending its foundation. Much of this confusion is due to the vacillating attitude of the propounders of economic principles; but then it is also true that this vacillation is in itself evidence of the intricacy of the subject-matter to be dealt with. It is not possible to doubt that the difficulty thus arising is due to the fact that the phenomena under examination, as well as the theory which deals with them, have been changing during the course of history, so that an analysis which would be accordant with the objects to be examined at a former period is no longer well-founded. In brief, we have here the opposition so often to be found in economic, and indeed in all social inquiries between the historical and the analytical method. Closer investigation of the basis of the

theory which we are considering will make the assertion still clearer. For wherein lies the first difficulty which perplexes the student? Is it not in the very conception of a separate "international" as opposed to other kinds of trade? The statement that there are special conditions which render this branch of exchange so peculiar as to need a different form of exposition, has been questioned, not only by untrained and sentimental writers,[1] but also by sober and eminent economists. And even among those who accept it, the reason which is assigned does not always bear a strict investigation.

To elucidate this matter, it is necessary to consider the origin of the distinction. It is beyond dispute that it is historical. The early writers on trade found that nations were in reality isolated, and, more especially since they treated economic matters from the side of art rather than of science, their attention was directed towards the various ways in which national prosperity might be increased. The strength with which mercantilist doctrines were held at that period led to a very general advocacy of restraints on the course of foreign trade, for the purpose of increasing national wealth, and also, in some cases, adding to the relative *power* of the State. The examination of the conditions under which such measures should be used formed a groundwork for a theory of international exchange, based, it is true, on erroneous views, but yet useful, as furnishing a starting-point for further development. The overthrow of mercantilism by Adam Smith and

[1] Thus Mr. Ruskin, *Munera Pulveris* (edition of 1886), p. 111, tells us, "International value is regulated just as inter-provincial or inter-parishional value is."

his followers, though it was accomplished by showing that the economic interests of nations were, for the most part, harmonious, nevertheless left the scientific problem open for discussion, and it is from this side that the theory has in reality been worked out. International trade is, then, in its development, as the very name implies, "trade between nations," so that it is necessary to explain what is meant by the term "nation" in ordinary and general use. Political philosophers have found it hard to give a concise and, at the same time, definite explanation; but here we may say with Mr. Freeman,[1] that "the word suggests to us a considerable continuous part of the earth's surface, inhabited by men who at once speak the same tongue and are united under the same government." Though the term "nation" is thus borrowed from political science, it is the economic features of the bodies coming under this description that have here to be noticed, since it is from them that the peculiar aspects of international exchange result; and economists have consequently followed this course. Bagehot, for instance, who would, on the political side, quite accept Mr. Freeman's description,[2] yet, from our special point of view, speaks of "a nation in the economic sense—that is, a group of producers within which labour and capital freely circulate";[3] and again, "English Political Economy, as we know, says that capital fluctuates from trade to trade within a nation; and it adds that capital will not, as a rule, migrate beyond that nation."[4] Thus, for the purpose of economic inquiry, the meaning

[1] *Comparative Politics* (1st ed.), p. 81.
[2] See *Physics and Politics*, chap. iii.
[3] *Economic Studies*, p. 240. [4] *Ibid.* p. 88.

of the leading term is altered, and a new connotation given to it, though the thread of connection between the two meanings is plain enough. Nations have been kept apart by various barriers of language, religion, mutual dislike, and, in most cases, by geographical distance, so that the economic conception of a nation is in truth a natural outcome of the facts of history. Still the alteration of meaning has to be carefully remembered, as well as the possibility in some cases of nations in the ordinary sense being excluded, and even more probably of some new cases being included in the new conception. Nor is it at all unusual to meet with these developments and amendments of popular language in economics. The term "rent," for example, instead of being "applied to whatever is annually paid by a farmer to his landlord," is confined, by Ricardo, to "that portion of the produce of the earth which is paid to the landlord for the use of the original and indestructible powers of the soil."[1] The analytical description of a "market," as given by Jevons,[2] is another instance, and many such cases may be found in other social sciences.[3]

The meaning which is thus conveyed by the word "nation" has, in some cases, been expressed by other terms which have, however, proved less convenient. In the *Wealth of Nations* it is of "every society or neighbourhood" that the mobility of labour and capital is predicated, and the later theory of international exchange would seem to be applicable to these "neigh-

[1] Ricardo, *Works* (ed. M'Culloch), p. 34.

[2] *Theory of Political Economy*, pp. 91-94.

[3] The treatment of some fundamental juridical conceptions, by Austin and the analytical school, at once instructively illustrates this process, and also shows its use in a kindred subject.

bourhoods."[1] Again, in Jevons' interesting examination of exchange, in his *Coal Question*, we have the term "trading bodies" used, as it appears, in a somewhat similar sense; but, on the whole, the old and long-established title has held its ground, and with good reason; for though the immobility of industrial agents may seem an insufficient justification for forming the boundaries of nations for the purpose of economic inquiries, still it cannot be denied that the political and economic boundaries do often coincide. It must, too, be noticed that both these classes of forces act and react on each other. The absence of the free and steady circulation of labour and capital helps to support political differences; while, as we have seen before, the political influences tend towards economic separation: and to the causes given above may be added the specially economic influences of different currencies and different financial systems. The operation of the various customs duties, too, is in itself a potent reason of estrangement between nations. From the point of view of social science in general, we may further say that international trade is trade between "societies," *i.e.* between the different social organisms which Sociology assumes as its field of investigation.

It results from the foregoing considerations that this description of a nation implies [two conditions, one positive, and the other negative, viz.—(1) The free circulation of labour and capital within each group; and (2) the complete immobility of all the agents of production as regards transfer to other groups.] To this assumption, however, objections from opposite sides

[1] See *Wealth of Nations*, book i. chaps. vii. x. Ricardo almost invariably uses the word "country" for this purpose.

may be and have been advanced. On the one hand, it may plausibly be argued that exchange is never between nations, but always between persons, either natural or artificial. Russia and the United States did indeed trade, when the transfer of Alaska from the former to the latter was arranged; but in almost every foreign exchange it is the individual member of a nationality which trades with members of another nation; and it may, therefore, be urged that as the laws of value do not change with climate or circumstances, there is no reason why the mere accompanying fact of immobility should alter the general law of the phenomenon? Some disputants would further argue that the laws of value should be simple, and reducible to one great general principle.[1] A conclusive answer to this class of objections is to be found in the fact that the power of free movement is essential for the existence of competition, and that value is altered by the presence or absence of that element; not, in any wise, by setting aside the so-called law of supply and demand, but by affecting the forces which are concisely described under that frequently misused phrase. The position of the parties under different social organisms, or different "nations," is thus a condition which affects the law of exchange, and which should be taken into account. The argument from simplicity, though supported by an appeal to "physical science," is but the old scholastic maxim that "Nature always acts by the simplest means," and

[1] "If, then, Economics is a Physical Science, and to be treated after the methods of a Physical Science, it is the essential condition of its being so that all the phenomena in it should be reduced to one grand General Theory."—H. D. Macleod, *Elements of Economics*, vol. i. p. 104.

does not need refutation. The supporters of these objections are not indeed agreed in their general views regarding economics, since some of them accept the Ricardian doctrine of cost of production as the main regulator of value, while others either rest on some vague account of "demand," or else appeal to moral and "human" considerations.

There is, however, another class of objectors who contend that it is not the adoption of the theory of international trade which is unfounded, but rather its limitation to any special cases. The principal representative of this opinion is Cliffe-Leslie, whose views are most distinctly given in the following passage:—

"The distinction which Mr. Mill has drawn between international trade and home trade, in respect of the transferability of labour and capital, and the equalisation of wages and profit, if it had once some foundation when trade at home was simpler and better known, and when foreign countries were almost wholly unknown, cannot now be sustained. Not that the doctrine of the equality of profits, and of the determination of comparative prices by comparative cost of production, is now applicable to both, but that it is applicable to neither. It was a step in the right direction to recognise its inapplicability to the exchanges between different countries; but the further step is now required of abandoning it altogether."[1]

The facts which form the basis of the argument contained in the above passage have been recognised by most modern writers on economics; but though the operation of competition—and its essential condition, the free movement of labour and capital—is, to some

[1] *Essays*, p. 232. The same argument is brought forward by Mr. Laughlin in his useful edition of *Mill* (see p. 379), and accepted by Mr. Devas (*Political Economy*, p. 288), who quotes with approval Ruskin's assertion already given. The discussion in the text seems to be a sufficient reply.

extent, impeded even in a single country, still the existence of special obstacles to transfer, in the case of international trade, cannot be denied. As we have seen, the influence of language, distance, special currency systems and other economic and social peculiarities, gives us a valid reason for regarding foreign trade as the particular field in which the immobility of the industrial agents may be best perceived. It is further to be remembered, that even if there is "no free competition between all the industrial groups within a country,"[1] still this of itself furnishes no sufficient reason for abandoning the special form of theory hitherto adopted for our subject. Two other courses are open to us, viz. either (1) to freely extend the theory to all non-competing groups, thus adding to the number of objects to be dealt with; or (2) to treat each nation as a compound group, including several minor bodies, to which in turn the theory may be applied, while the exposition of the general doctrine is modified by the presence of these groups, so far as in fact they alter the operating forces. The objections, therefore, urged from so many different points of view against the theory of international trade, which has been a noteworthy product of the English economic school, may be either traced to misconceptions regarding its nature, or be set aside as irrelevant.

It remains to examine the precise nature of the immobility which has been assumed as the foundation of the theory. If by it be meant that labour and capital never pass beyond the bounds of a nation, it is plain that such an assertion is opposed to the most obvious facts. Superficial observation would rather

[1] Laughlin's *Mill*, p. 379.

select the great freedom of movement possessed by both these agents of production as a striking feature of the present economic period. It may with reason be held that, "a cosmopolitan loan fund exists which runs everywhere as it is wanted, and as the rate of interest tempts it."[1] The mobility of labour, it is true, is much less pronounced, but it is as certain as any future event can be, that this tendency will become stronger as the means of communication are further improved. It would, however, be a complete misapprehension of the real basis of the "international trade" theory to suppose that absolute fixity of the industrial agents is required in order to render it applicable. The truth on this subject has been very well stated by Cairnes, who points out that—

> "It is by no means necessary to the truth of the doctrine, as it has been laid down, for example, by Ricardo and Mill, that there should be an absolute impossibility of moving labour and capital from country to country. What the doctrine requires is not this, but such a degree of difficulty in effecting their transference as shall interfere substantially and generally—that is to say, over the whole range of the commodities exchanged—with the action of industrial competition."[2]

It is extremely likely—to take a hypothetical case—that double wages or double profit, in any country, over those to be obtained elsewhere, would cause a rapid migration to the country where those specially high gains were to be obtained; but it is not so clear that an advantage of one-fifth, or twenty per cent, in either wages or profits, would cause a movement of labour and capital. Another point needing consideration is, the evidence which such high rates of wages

[1] Bagehot, *Economic Studies*, p. 89. [2] *Leading Principles*, p. 363.

and profits, as are assumed in the former instance, would afford of the existence of special conditions of production, which would of themselves suggest the adoption of a special theory for cases of exchange between the supposed country and other lands, where industry was carried on under less favourable circumstances. It is plain, too, that if the movement brought about a reduction of gain in the favoured country of our supposition, at some point the obstacles set by the various retarding elements previously noticed would again arise, and, as a necessary consequence, with a new distribution of the sum of industrial forces, a new series of "international exchanges" would be carried on. The exact amount of difference in wages and profits which will cause movement from country to country can only be ascertained by observation; as might be expected, it varies in different countries and different periods. On the whole, it ought to be sufficiently plain, that in the fact of difficulty of movement there is an adequate reason for the special form of exposition that we are about to adopt. It is requisite also to add, that the other features of difference which each country exhibits in its economic arrangements—such as its currency, its commercial legislation, its peculiar language and sentiments; in short, the existence of national character in the widest sense of the term, entirely apart from their effect in producing, or at least increasing, the difficulty of transfer, which is the main condition in operation—justify fully this line of investigation.[1]

[1] Signor Lorini (*La Mometa e il Principio del Costo comparativo*, pp. 82-84) regards the discussion in the text as "complicated" and "dangerous." He seems to overlook the importance for the theory

A clearer illustration of the exact application of the term country, or nation, might also be here desired. We may be asked—Does trade between England and Ireland come under the category of foreign or domestic trade? And if it be referred to the former, we may next be asked—Under what head is trade between Ulster and the other provinces to be dealt with? And thus by degrees the field may be reduced till we come down to trade between individuals. The answer to such a question must be made with reference to the particular facts of each case, and no general explanation will suffice. To take the instances just indicated. It seems to be undoubtedly true that trade between England and Ireland is rather "international" than domestic, even though some important features of "foreign trade" are absent. Again, exchange between the different provinces of Ireland seems rather to be domestic than "international," since the connection of the banking system of Ireland is very close and compact, and the rate of profit, as well as of wages, apparently tends to a common level. It is of course possible that on fuller investigation reasons for treating this last case as "international" might appear; and also for certain purposes it might be convenient to regard the United Kingdom as a single body, composed of several non-competing groups. Nothing but observation can completely solve difficulties of this class.[1]

of international trade of forming a clear conception of the varied influences that build up the barriers hindering the flow of labour and capital. The complication exists in the nature of things, and apparent simplicity can be gained only by ignoring real elements in the problem.

[1] "The obstacles to the free movement of labour and capital, which

The reasons for a particular theory of foreign trade have now, it may be hoped, been sufficiently set forth. There is, however, one misconception, which, as it is suggested by the statements of Mill, needs to be examined. In several passages of the *Principles* it is implied that the fact of distance is the only reason for adopting a peculiar form of exposition, and foreign trade is regarded as being one instance of the wider case of trade between distant places.[1] It is true that the whole course of the discussion contained in his several chapters on foreign trade and values makes it clear that it was the immobility of labour and capital which, in Mill's opinion, so altered the phenomena of foreign trade, and that he has merely dwelt on distance as being one prominent cause of that immobility; but unfortunately, when trying to assail the system of a great writer, it is easier to select detached passages for criticism than to judge the exposition of a connected and developed theory; and we therefore find that Mr.

produce the conditions called 'international,' are, according to Cairnes, '(1) Geographical distance; (2) difference in political institutions; (3) difference in language, religion, and social customs—in a word, in forms of civilisation.' These differences exist between Maine and Montana, or even between two adjoining States, Ohio and Kentucky."—Laughlin's *Mill*, p. 379. Cherbuliez would regard trade between the different Swiss Cantons as being international, *Précis*, vol. i. p. 376. The trade between England and her colonies is undoubtedly international; but in all these cases the political element is, to some extent, to be found. If the adoption of a new term were permissible, "region" would perhaps best suit the purpose; but "inter-regional" would prove a troublesome word: it is therefore better to adhere to the old term.

[1] "Does the law that permanent value is proportioned to cost of production, hold good between commodities produced in distant places, as it does between those produced in adjacent places? We shall find that it does not."—Mill, *Principles*, iii. 17, § 1.

Macleod has selected this doctrine for attack, by pointing out that distance is a matter of degree, and that it is impossible to fix the boundaries between domestic and foreign exchanges: and, granting that such was Mill's view, his position seems incapable of defence. This misinterpretation of the theory has been accepted by Mr. Sidgwick, who proceeds to develop a theory of the conditions determining value between distant countries, based on the existence of a double cost of carriage—a doctrine which will need examination, when we reach the problem of value, but which, it may be said at present, is inconsistent with the basis of the theory as we have stated it above.

We have now before us the elementary facts to which the doctrine has to be applied, viz. the various groups which, as we at present assume, exchange commodities, but between which industrial agents do not pass. It is important to see clearly the nature of the trade thus established. Will it not be exactly the same as trade carried on between separate individuals, who may indeed exchange the products of their labour, but cannot transfer their special industrial aptitudes? The reason for all exchange is the increase of utility resulting therefrom—a reason which applies to non-competing groups, as well as to individuals; each exchange, however, necessarily implies an increase of utility, or at least the expectation of it by those who are best fitted to judge—the actual exchangers—and it further implies an increase of utility on each side. There is, moreover, no relation between the sacrifices incurred on one side and those undergone by the other. An individual about to exchange one commodity for another, does not consider the efforts of the other party

to the exchange; he simply seeks his own satisfaction. The cost of the article that he receives is, for him, determined by the sacrifice which he incurs in producing the commodity given in return, from which it follows that, with all goods obtained through exchange, the cost of production is replaced by the cost of acquisition.[1]

Illustrations of this fact abound. The professional man who, with a single fee—the payment for, perhaps, a few moments' attention—obtains a ton of coal or more, does not incur anything like the sacrifice that the collier does, who has to devote hour after hour of hard toil to obtain a similar result. Again, it is evident that the more skilful producer may yet find it for his advantage to obtain a product by exchange, and thus avail himself of his still greater skill in producing another commodity. The often-quoted instance given by Ricardo may once more be used:—

"Two men can both make shoes and hats, and one is superior to the other in both employments; but in making hats he can only exceed his competitor by one-fifth, or 20 per cent, and in making shoes he can excel him by one-third, or 33⅓ per cent. Will it not be for the interest of both that the superior man should employ himself exclusively in making shoes, and the inferior man in making hats?"[2]

A simple calculation shows that both parties gain by such an arrangement.

These facts, which, in our modern societies, are masked by the complex organisation of industry, or

[1] "What everything really costs to the man who wants to acquire it, is the toil and trouble of acquiring it."—*Wealth of Nations* (ed. Nicholson), p. 12.

[2] *Works*, p. 77.

are referred to the working of other forces, as, *e.g.*, competition, obtain prominence in the theory of international trade. It is there distinctly recognised that the cost of a country's imports must be measured by that of its exports, and that the former is the satisfaction for which the latter is the necessary sacrifice —a view which at once disposes of the cruder forms of Protectionism. The other cases are necessary and simple deductions from the formula which is accepted as that governing foreign trade, viz. the law of comparative cost,[1] which has been succinctly stated by Cairnes in the following terms:—

"The one condition at once essential to, and also sufficient for, the existence of international trade is a difference in the comparative, as contradistinguished from the absolute, cost of producing the commodities exchanged."[2]

This principle is undoubtedly the main regulative condition of international exchange; but it has been so often misunderstood and misinterpreted that some further development is needed. And, first, it may be said that the comparison is not one of prices, but of sacrifices. The scale of prices in different countries depends on conditions which will need examination later on; but for the present, trade must be treated as if it were all carried on in the form of barter. A second point requiring explanation is the statement that comparative cost is the sufficient condition for international exchange. This assertion is only true if

[1] This expression was, probably, first used by J. S. Mill, in his *Essays*, p. 2; but the principle is substantially to be found in Ricardo, and is further worked out by James Mill *Elements*, p. 88.

[2] *Leading Principles*, p. 372.

all retarding elements—all those hindrances which arise from cost of carriage and customs duties—are neglected, and then only if the inquiry is confined to two countries. A third point of equal importance is the exact comparison which is to be made. "The costs compared, it must be carefully noted, are the costs in each country of the commodities which are the subjects of exchange, not the different costs of the same commodity in the exchanging countries."[1] Or, in other words, it is the productive powers of the exchanging countries, applied under different circumstances, that have to be taken into account and their results compared. And, finally, it may be said that all foreign trade is carried on within the limits set by comparative cost of production.

From this law has been deduced the apparently paradoxical doctrine that it may be a country's interest to import a commodity which it could nevertheless produce with less cost than the exporting country. The illustration quoted above from Ricardo is used by him to show this fact; and as it is plain that there may be a difference in the comparative cost under the circumstances supposed the case is evidently possible, while Bowen and Cairnes have brought forward actual instances in the case of the trade between New York and Barbadoes, as also in that between Australia and Ireland.[2] Another paradox, which has also been illustrated

[1] *Leading Principles*, p. 373.

[2] Bowen, *American Political Economy* (1st ed.), p. 460. Cairnes, *Leading Principles*, pp. 376-377. The trade of the Channel Islands with England supplies another illustration. Jersey could produce wheat more efficiently than England, but she finds it more advantageous to grow fruit and early potatoes, importing the corn that is required.

in the case of individuals, can be deduced from the principle of comparative cost, viz. that it may be for the interest of a country to produce an article for the production of which it appears to possess less technical facilities than it does for that of another article which it may nevertheless find it to be more profitable to obtain by exchange. Here, again, the principle of comparative cost, as stated above, shows the possibility of the case; and it may be plausibly conjectured that the difficulty which American manufacturers find in competing with English producers, notwithstanding their abundant natural resources, is an illustration in point.[1]

Though, for the purposes of theoretical exposition, the extreme cases we have been just considering attract most attention, since it is on their existence that most of the shallow objections to the theory are built, it yet would be a serious mistake to regard all, or even the greater part, of foreign trade as being of this kind. In the most numerous instances, each country obtains articles for the production of which it has no great facilities, by exporting those goods which it produces with comparative ease. The coal and iron of England

[1] The cases given above may be illustrated symbolically in the following way. Let A and B be the two nations or individuals in question, x and y the commodities. Let it be assumed that each nation has two units of productive power, each of which can in A produce $2x$ or $3y$, in B x or $2y$. Then, if there is no interchange, the total production will be $3x+5y$, while if each country confines its production to that commodity in which it has the greatest *comparative* advantage, the total will be $4x+4y$; but it is evident that x is more valuable than y, since more productive power is needed for its creation (viz. in A, $\frac{1}{2}$ unit against $\frac{1}{3}$; in B, a whole unit against $\frac{1}{2}$). Therefore it is expedient for A to produce x only, and for B to produce y only. It is, moreover, evident that A has superior facilities for the production of *both* commodities.

are exchanged against the wines and silks of France, with great advantage to both the parties concerned, and such is the normal character of international exchange. The rule is, that each nation exports those commodities for the production of which it is specially suited, obtaining in return articles which it could not so easily make for itself.[1] The exceptional cases are those in which (1) a nation of superior powers imports an article which it is, so far as technical reasons are concerned, better able to produce for itself; or (2) gives up the production of an article for which, on technical grounds, it seems better suited than for those which it actually exports. The general advantages of international trade may then be all included in the one phrase, "increase of utility." By means of exchange a nation obtains a greater amount of satisfaction, with a given effort, or a given amount of satisfaction, with a less effort; and thus discharges, in a better manner, its function as an economic machine.

The gains may, perhaps, be better realised by regard-

[1] Mr. and Mrs. Webb (*Industrial Democracy*, vol. ii. pp. 864-865) are mistaken in supposing that the proposition in the text rests on a confusion between "cost" of production and "expenses" of production. It was in part with the intention of emphasising the difference between the two ideas that "international values" were treated (in chap. ii.) before the subject of "money" was introduced (in chap. iii.). Nor does there appear to be any foundation for characterising the statement as "optimistic." It is rather the assertion of a somewhat obvious feature of foreign trade. It would be unjust without very conclusive evidence to attribute to the authors of *Industrial Democracy* the belief that the greater, or even a moderately large, part of the export trade of the world is carried on by—to use their term—"parasitic industries." There is, however, some satisfaction in obtaining the high authority of Mr. and Mrs. Webb for the doctrine that "the existence of parasitic trades . . . adds no weight to the case for a protective tariff" (*Industrial Democracy*, vol. ii. p. 865).

ing them in a more concrete way. From this point of view it appears that a nation gains the following advantages by its foreign trade:—1st. It is able to procure commodities which it is absolutely unable to produce itself—tropical spices furnish a good example. 2nd. It obtains commodities which it could not produce with the same facility, even from the technical aspect; and it may be noted, that between this case and the first, the difference is sometimes very slight. There are very few articles which could not, to some extent, and by sufficient outlay, be produced in any country. "By means of glasses, hot-beds, and hot-walls," says Adam Smith, in his celebrated *reductio ad absurdum* of the mercantile theory, "very good grapes can be raised in Scotland, and very good wine, too, can be made of them, at about thirty times the expense for which at least equally good can be brought from foreign countries."[1] In fact, there are many commodities which could not be produced in sufficient quantity, or at a price low enough, to induce consumers, but which are easily obtained by means of international exchange. Again, there are many articles which could be produced at a moderate cost at home, but which can be gained at still lower terms, owing to the superior resources of other countries. 3rd. The case of a country, with superior powers of production, importing from one which is inferior in all respects, comes next in order, and the examples already given need not be repeated. 4th. The productive force of each community is set free for application to those natural agents and materials which offer the best chance of high returns, so that the efficiency of each productive unit is much increased. 5th.

[1] *Wealth of Nations* (ed. Nicholson), p. 185.

The concentration of special branches of production in one place leads, as the law of increasing return so generally applicable to elaborative industry implies, to further gain. This advantage is nothing else than one of the advantages of division of labour, since international exchange is really, what Torrens[1] has well called it, "the territorial division of labour."

In enumerating these several advantages, no place has been made for that which is most often put forward in popular discussions, viz. the creation of new markets for exports. At the same time, the bond which, as we shall see, connects all international trade, and establishes a definite relation between imports and exports, must not be lost sight of. As has been already said, exports are the sacrifice made in order to obtain imports, and anything that makes the gain by exchange greater, which new markets may do, ought not to be overlooked in a complete theory. The truth is suggested (if we make allowance for looseness of expression) in Adam Smith's statement, so severely commented on by Mill,[2] that foreign trade "carries out that surplus part of the produce of their land and labour for which there is no demand among them, and brings back in return for it something else for which there is a demand." If "surplus" and "demand" be understood in a comparative sense, then this passage very fairly sets forth the real advantage of foreign, as indeed of all, trade, that is, the increased utility which results therefrom.[3] It is highly probable that the

[1] *The Economists Refuted*, p. 14.

[2] *Wealth of Nations*, p. 181; cp. J. S. Mill, *Principles*, iii. 17, § 4.

[3] In reality all exchange is of the "comparatively superfluous for the comparatively necessary" (Jevons, *Primer*, p. 97); or to use the

opening of new markets will stimulate industry, and also bring about a better adjustment of productive force. The powerful influence of foreign trade, in developing increased industrial energy among nations at an early stage of development, has been pointed out by Mill; but his statement may be extended to the case of an increased foreign demand for an article which may increase the industry of home producers.

The social and moral effects of foreign trade, though in no respect inferior to the purely economic ones, may best be reserved for that part of our inquiry in which we deal with the applications of the theory.[1]

quaint language of Dudley North, "Trade is nothing else but a commutation of superfluities."—*Select Tracts on Commerce*, p. 516.

[1] For discussion of the possible disadvantages arising under international trade, see the present writer's *Commerce of Nations* (2nd ed.), pp. 17-21; also the articles "Free Trade" and "International Trade," in Mr. Palgrave's *Dictionary of Political Economy*.

CHAPTER II

THE THEORY OF INTERNATIONAL VALUES

THE general account of the character of, and the advantages which result from, international exchange given in the preceding chapter, suggests a further investigation of great importance, but one which will necessarily be of a somewhat complicated kind. It may concisely be stated in the following shape:— What are the conditions which determine the division of the gain resulting from foreign trade among the different parties to the exchange? Or, In what way will the values of commodities which are the subject of foreign trade be affected by the conditions under which that trade is carried on? In working out this problem, it will be most convenient to follow somewhat closely the course adopted by J. S. Mill, not only since his treatment is the most thorough, but also because students have generally gained their first notion of the subject from his pages.[1]

Let it, then, be assumed that there are but *two*

[1] Professor Nicholson, in his important *Principles of Political Economy* (vol. ii. pp. 268 *sq.*), has followed Cournot by handling the problems of foreign trade in terms of money without any preliminary discussion from the point of view adopted in the text. His treatment is interesting and suggestive, but, on the whole, the older method appears to be preferable. For a fuller notice see Appendix C.

nations, countries, or "trading bodies" in existence, and that these nations trade in but, indeed we may say can produce only, two commodities. Let the countries in question be styled A and B, the commodities x and y. Let it further be granted that a unit of productive power in A can produce $10x$ or $20y$; and that a unit of productive power in B can produce $10x$ or $15y$. It follows, from the law of comparative cost, that it will be the interest of A to confine itself to the production of y, and of B to devote its resources to the production of x. The question which has now to be answered is: What are the terms on which the exchange of x and y will take place? And in the answer to that question lies the solution of the problem of international *values*, as distinguished from that of international *trade*.

Before, however, entering on this inquiry, it will be best to dwell for a little on some assumptions made in, and on some special features of, our supposed case. (1) It is assumed that the commodities x and y are both capable of being proportionally increased up to any assignable limit by a proportionally increased amount of productive power, from which it follows that their value is determined by, or at least moves parallel with, their cost of production, so that in A $10x$ will exchange for $20y$, and in B for $15y$. The existence of different costs of production for different amounts of commodities produced, of a set of non-competing industrial groups, and of all those retarding agencies which have been loosely summed up under the name of "custom," are for the moment ignored. Nor is such a method of procedure illegitimate. The expediency, and even the necessity, of employing pro-

visional hypotheses in economic observation, has been recognised by Leslie as well as by Cairnes, by Dr. Ingram as well as by Mr. Sidgwick. In Germany it is conceded by Schmoller.[1] The real error lies, not in the use of hypotheses, but in forgetfulness of the fact that they are unreal, or, at all events, incomplete. (2) The term "productive power" may be noticed. It is used to escape the awkwardness, if it be not something more, of estimating the exertions of a country in units of labour or of capital—a mode of procedure which leaves it open to the critic to speak of the omitted element as if it were an essential condition.[2] There can be little difficulty in conceiving a given amount of labour working with an average amount of capital, and thus producing a definite amount of a commodity. (3) There is a further caution which will save the student from some confusion as he proceeds; it is that the "units" spoken of need not necessarily, or even usually, be the same in both countries; for instance, the unit in A may be one day's labour and £5 capital; in B it may be ten days' labour and £30 capital. The apparent equality of productive power in the case of the commodity x—10 in each country—is adopted to secure, as it were, a common denominator, and to enable the division of gain to be more easily understood. (4) Finally, we must add that all impediments to exchange, arising

[1] Cp. Leslie, *Essays*, p. 158; Cairnes, *Logical Method*, pp. 77-84; Ingram, *History of Political Economy*, pp. 187, 242; Sidgwick, *Principles*, Introduction, chap. iii.; Schmoller, *Jahrbuch* (1888), p. 256.

[2] Thus Cournot, *Théorie des Richesses*, p. 344, objects to the undue exaltation of capital by the English school, though, curiously enough, it is labour that Ricardo and J. S. Mill mainly consider in their theories of international value.

from cost of transport and from customs duties, or any other cause, are for the present neglected.

Having cleared the way by the foregoing remarks, let us now follow out the working of our hypothetical case. When each country produced for itself, the total production was $20x + 35y$. When each country applies itself to the product in which it has the greater comparative advantage (or less disadvantage), the total production becomes $20x + 40y$, that is, a gain of $5y$. It is the conditions which determine the division of this amount of $5y$ between A and B that must now be looked for. The analogy between international and individual exchanges, as pointed out above (p. 13), seems at first to suggest that the problem is a hopeless one, for if A and B were individuals, it is plain that the ratio of exchange might lie anywhere between $10x$ to $15y$ and $20y$. In fact, we come to what Jevons has called the "failure of the equations of exchange";[1] and such is substantially the conclusion at which J. S. Mill arrived on closer reflection.[2]

There are, however, several modifying circumstances in international, as opposed to individual, exchange which assist us in indicating generally the conditions that we are in search of. Why, it may be asked, should the terms of an exchange between separate individuals be so hard to predict? Simply because it is hard to get the needed information. "The result of the bargain," in a case of the kind, "will greatly

[1] *Theory of Political Economy*, p. 134.

[2] Cp. "Ten yards of cloth cannot exchange for more than twenty yards of linen, nor for less than fifteen, but they may exchange for any intermediate number."—*Principles*, iii. 18, § 2, with iii. 18, § 6, and iii. 18, § 8.

depend upon the comparative amount of knowledge of each other's positions and needs which either bargainer may possess or manage to obtain, in the course of the transaction. Thus the power of reading another man's thoughts is of high importance in business, and the art of bargaining mainly consists in the buyer ascertaining the lowest price at which the seller is willing to part with his object, without disclosing, if possible, the highest price which he, the seller [buyer?], is willing to give. The disposition and force of character of the parties, their comparative persistency, their adroitness and experience in business, or, it may be, feelings of justice or of kindliness, will also influence the decision."[1] In such a case even the main influencing force—the comparative urgency of demand—is unknown to an outsider. In international exchange, on the other hand, there is the steadying effect produced by the existence of a large number of persons on each side. It may be impossible to estimate the amount of x which A (an individual) would give for y; but if A be a body of persons, its demand will come under the law of averages, and can, with the aid of statistics, be determined within tolerably narrow limits. Returning to our particular case, let us assume that the trade between A and B is opened at the ratio—suppose of $10x$ for $16y$. At that rate we find that 1000 times $10x$ is demanded by A, and that 1000 times $16y$ is demanded by B, and that thus there is no unsatisfied demand on either side; it follows that the trade is in equilibrium, and that $10x$ to $16y$ will be the ratio of exchange. A will gain $4y$,

[1] Jevons, *Theory*, pp. 134-135. Cp. Bagehot, *Economic Studies*, pp. 136-145.

and B will gain $1y$, by the opening of the trade. The result may, however, be different; for A may require a larger amount of x at the ratio $10x$ to $16y$, say 1100 times $10x$, while B only requires 1000 times $16y$ at the assumed ratio. It will therefore be necessary for A to offer a greater amount of y in exchange for x, say $10x$ for $17y$. Now, it is apparent that at this new ratio A cannot require more than it would at the lower rate, and, in all probability, will require a less amount, which we shall suppose to be 1050 times $10x$. On the other hand, B cannot require less of y at the new ratio than at the older and more unfavourable one, and, indeed, will be likely to require more, which increased amount we shall assume to be 1050 times $17y$. Here, again, we have a state of equilibrium, the demand on either side being satisfied. It is possible that several ratios may satisfy the condition to which, as we have just seen, international exchange conforms; but, owing to the fact that large groups of persons are the source of demand on each side, it is probable that the equation of demand once satisfied will not lightly be departed from, so that, to some extent, it will not only be a position of equilibrium, but also one of stability, though, in some cases, a departure from it would perhaps lead to a new state of equilibrium at a different ratio.

The foregoing inquiry leads directly to J. S. Mill's conclusion in his first and soundest exposition of his theory. [The ratio of exchange, in the case of commodities which are the subject of international trade, depends on the comparative intensity of demand on each side, always, of course, operating within the limits set by comparative cost.] As Mill has pointed

out, it is conceivable that all the gain by exchange would go to one country; for, suppose that A only requires a limited amount of x, which will not be increased by a reduction in its value, while B requires a large amount of y, it is possible, and, under such conditions, even likely, that the terms of exchange will be $10x$ for $15y$, since B, in order to satisfy its demand for y, will offer increasingly favourable terms, even up to the limit set by its power of producing y for itself.

This "first elementary principle of international values,"[1] important as it is, stands in need of large developments and additions before it can be applied to actual cases. Up to the present we have paid no attention to the industrial constitution of the countries or nations whose supposed bartering we have been using as a guide in our inquiry. The proposition just developed may be further explained by looking at the results of different systems of organisation. If we make the unlikely supposition that A and B are both "socialistic" States, the exchange will then be in form exactly the same as that between individuals. The ratio of exchange must be arranged by treaty, and will be a high act of State,[2] so that any attempt to determine it would be practically impossible. When the usual state of individualistic industry is to be found, we have seen that reciprocal demand may be regarded as a fairly steady condition for determining the ratio of exchange; but it appears that it is possible

[1] J. S. Mill, *Principles*, iii. 18, § 2.

[2] For a good argument against socialism, based on the difficulty of conducting international trade under that *régime*, see Leroy-Beaulieu, *Le Collectivisme*, pp. 393-399.

to alter the ratio by means of the combination of dealers on each side. It is, as we shall see, also possible to affect the ratio of exchange by the imposition of charges on the act of exchange, or on the transfer of the commodities from country to country;[1] still the fundamental condition is what Mill has called "the equation of reciprocal demand," and all other operating forces work through it.[2] It is therefore requisite to see the extent to which the results attained by our purely hypothetical case are affected in the complex conditions of international trade. We may first give up the conception of the commodities x and y as being always produced at a fixed cost, and regard them as subject to the laws of diminishing or increasing return; the consequence which will necessarily follow is, that the limits set by cost of production which, up to the present, we have regarded as fixed become movable. Increased demand for a commodity subject to the law of diminishing return, will remove the limits set by comparative cost, and may also allow of the commodity being partly produced in both countries; thus, in the case already considered, some units of productive power in B may produce $25y$, others $20y$; but the unit on the margin will, *ex*

[1] See Chap. VII.

[2] The attempt made by Mill to amend his theory by introducing the additional element of the amount of capital set free for the production of exports is, as he even seems to admit, a failure; for, in the case of two countries and two commodities, the amount of freed capital, or, as I should prefer to say, "productive power," is evidently determined by reciprocal demand, so that nothing is gained by the laborious and confusing discussion in secs. 6, 7, 8 of chap. xviii. Professor Edgeworth's authority may be quoted in support of this criticism. See his "International Values" in *Economic Journal*, vol. iv. p. 609.

hypothesi, produce but $15y$. Now, when international exchange commences at, say, $10x$ to $17y$, all units in B which produce less than that amount are withdrawn from the production of y, and directed to that of x; but those which produce $17y$, or any greater amount, remain employed as before. The law of diminishing return may also affect A. Some units there may produce $40y$, some $30y$; but those at the margin will, *ex hypothesi*, produce but $20y$. The extended production which results from increased demand will probably lower the margin of cultivation, or, to speak more generally, of production; but when the margin comes down to $17y$, there will be no further gain by international exchange to A, so long as $17y$ is given for $10x$. The law of increasing return operates in the opposite direction; thus, if the increased demand for y, which arises from the growth of international exchange, causes it to be produced in A with greater ease, so that each unit will produce, say, $25y$, then it is clear that, in order to dispose of the additional supply, y must be offered at lower terms; and it may also be inferred that if y be subject to the law of diminishing return in B, as we have supposed, some more units of B's productive power will be withdrawn from the production of y and devoted to that of x. It is of course not likely that the same commodity will be subject to such contrasted conditions in two different countries. It is, however, possible that the recent development of agriculture in the United States and Canada has taken place under the law of increasing return, and that its effect on British farming is more noticeable, since the latter comes under the law of diminishing return. The same con-

siderations may, too, explain the predominance of a manufacturing country, when once attained, since its productive power is steadily increasing, and thus extending the field of international exchange to the dismay of the native producers of manufactures in other countries: but whatever be the limits of their operation, it is demonstrable that the operation of the law of diminishing return tends to limit the area of international exchange, while that of the law of increasing return is calculated to extend it.

Another of our assumptions has been that there is perfectly free competition, which implies complete mobility of labour and capital within each of the countries or nations A and B; though, in considering the general features of the subject, we have seen that both these factors of production are, in a greater or less degree, impeded by the existence of customary conditions, as well as by the ignorance of producers, which is a necessary result of the great and increasing complexity of industrial organisation.

It now becomes necessary to consider the effect which the admission of this new element produces on the rates of international exchange. It is evident that hindrances to free competition may take one of two forms; for the whole body which produces x in either of the countries A and B may be rigidly marked off from that which produces y, or, again, each of those commodities may be produced by a number of groups which are not in effective competition with one another. In the former case, the element of cost of production is absent as a regulator; and, in truth, the producers of x and those of y are two completely distinct trading bodies, or in the economic use of the

term, "nations"; so that we have reached the complex case of three or more trading bodies which we shall investigate later on. In the second form of arrested competition it is probable that some of these groups will be in effective competition with the producers of the other commodity, be it x or y; and to that extent, the changes in the distribution of productive power will be just as in the case of perfectly free competition. Where competition is arrested, the group will be to that extent a distinct nation, and will have to be treated as such. The limits which custom, and, in less degree, cost of transport, set to effective competition are, in general, not of so rigid a character as has just been represented. The production in an industry which is carried on under customary conditions, or with exceptional advantages of any kind, whether resulting from situation or training, will not indeed alter under any slight change in the terms of supply brought about by the opening or development of foreign trade; but a large and sweeping variation will tend to break down the barriers of even the best-established custom, and to neutralise the effect of special aptitudes or facilities.

One peculiar feature of changes in the relations of non-competing groups, which is brought about by foreign trade, ought to be emphasised. We have seen that the advantage of foreign trade is due to the superior productiveness of industry, in consequence of its more efficient operation, by being applied to those industries only in which it possesses a relative advantage; and for this object, an actual change in the distribution and employment of productive force is needed. Where, however, there is no effective com-

petition, no change can take place, and what really happens is a readjustment of the terms of exchange, so that what is gained by one group is lost by another, and, in appearance, there is no advantage to the country as a whole. On closer examination it will be discovered that a real advantage is gained, but that it consists, not in a more effective employment of productive power, but in the breaking down of a monopoly. For let it be assumed that the conditions of exchange in B are such as to establish the terms of $10x$ for $15y$, and further, that this ratio is the result of supply and demand, unaffected, or only partially affected, by cost of production; now, if by foreign trade the terms of exchange would be so altered as to give $10x$ for $17y$, but that the producers of y, being a non-competing group, are unable or unwilling to transfer their efforts to the production of x, and, instead, are ready to give $17y$ for $10x$, so that there is no necessity for carrying on foreign trade, is it not evident that the producers of y have hitherto been in possession of, at least, a qualified monopoly, by means of which they have been able to exact from the producers of x peculiarly favourable terms, and that by the opening of foreign trade this monopoly has been abolished, or to some extent diminished? The same considerations apply to the case of personal or local aptitudes, the gains of which always tend to be reduced by the opening up of other sources of supply. The importance, in a practical sense, of this fact will be best seen in relation to the protectionist controversy.

Up to the present we have retained the main elements of our original hypothesis, viz. two "nations," two commodities, and absence of all impediments to

exchange. In order to approach, in some degree, the complexity of actual trade, let us insert each of the omitted elements, but in reverse order. Retaining the idea of two countries and two commodities, we first add the element of cost resulting from impediments to exchange, whatever be their character. To the legitimacy of this procedure, as adopted by Mill, objection has been made by Mr. Sidgwick;[1] but by the manner in which the general problem has been stated in the preceding chapter, this difficulty has been removed. Cost of transfer is not a necessary element in exchanges between individuals, or even between adjacent groups, and in many cases it is a very slight one.[2]

The effect of impediments will, of course, be to lessen the gain by foreign trade. In our hypothetical case we saw that $5y$ was the gain obtained by the opening of international exchange; but if we assume that the ratio of exchange is $10x$ to $17y$, and that the cost of transfer of each of these amounts is $1y$, the gain will be reduced to $3y$, and the ratio of exchange will not, in general, be the same in both countries, since the cost of transfer, or some of it, will have to be added to the commodity in the importing country. It follows that the alteration of value will produce a readjustment of the terms of international exchange; but it is impossible to say in what way the loss, arising from the sum of impediments, will be divided between the two countries. We have seen

[1] *Principles*, p. 206.

[2] It is not at all clear that Mr. Sidgwick's criticism would hold as against Mill. Even granting that cost of carriage is a necessary element, may it not still be legitimate to make provisional abstraction of it, in order to facilitate reasoning?

that in one unlikely case the whole gain of exchange might accrue to one country (p. 28), and under similar circumstances the whole cost of transfer might be placed on one of the parties; thus, if in A the demand for x was so intense as not to be reduced by its higher value, while in B the demand for y was so weak as to decrease more than proportionally to its rise in value, then the whole cost would fall on A, and the value of y would be the same in both countries, though, as, in such a case, B would, if there were no cost of carriage, have obtained the whole gain from foreign trade, the impediments would in reality be a deduction from its gains. It may, at any rate, be said with confidence, that the effect of impediments on foreign trade is, in general, to inflict a loss on both parties, but that we do not possess sufficient data to enable us to divide the amount of loss, any more than that of the total gain from foreign trade.

Impediments to transfer are—as Mill remarks—one, but not, as he seems to assert,[1] the only reason for the production of the same commodity in different, or, to keep to our case, in both countries. Let us assume, what is not unlikely, that the cost of placing $10x$ in A, and $17y$ in B, will come to $6y$, then the total gain—$5y$—will be swallowed up, and be replaced by a loss of $1y$; so that the exchange would cease. The existence of impediments to transfer is, in fact, a tendency operating in somewhat the same way as

[1] "Cost of carriage has one effect more. But for it, every commodity would (if trade be supposed free) be either regularly imported or regularly exported. A country would make nothing for itself which it did not also make for other countries."—*Principles*, iii. 18, § 3.

the law of diminishing return, the effect of both being to limit the field of international exchange.

Another step towards reality may now be taken. Let us assume that A and B produce not x and y only, but also a third commodity z, and that one unit of productive power in A will produce $100z$, while one in B will only produce $90z$. Previous to the introduction of z, the terms of exchange have been, suppose, $10x = 16y$. B is now able to offer to A not x only, but also z, and it will be A's interest to take some of the commodity z at $17y = 90z$, as there would be a gain of $5z$ by the transaction, since in A $1y = 5z$ $\therefore$ $17y = 85z$. The exact terms of exchange will depend on the amount of x and z required by A compared with that of y by B; but whatever it may be, there is no doubt but that B's position, as a trader, will be improved. In like manner, a commodity w may be added, whose conditions of production are such that a unit of productive power in A produces $50w$, in B $40w$; here, if the ratios of exchange be, as would follow from the last case, $10x = 17y = 90z$, it will be A's interest to offer $45w$ for $10x$, since it thus gains $5w$; it is, too, for B's advantage to accept these terms, as it will also gain a similar amount.

The actual rates finally established will, in the more complex as in the simpler case, depend on the play of reciprocal demand; but it cannot be overlooked that the introduction of several commodities on each side will produce a steadying effect, in addition to that exerted by the presence of a large number of dealers and consumers. The terms of exchange will be set by the comparative demand of each nation for all the products of the other, which are the subject of foreign

trade; and it is further implied in the very fact of exchange that "the exports of each country must exactly pay for the imports" (the cost of carriage being omitted). The extreme limits within which the terms of exchange can vary, will be set by the difference in the comparative cost of production of those commodities in respect to which the difference is widest; but as any tendency to move close to either of those points will be accompanied by a diminution in the number of articles entering into the trade and in the sum of exchanges, with a consequent reduction of the total amount of gain, it will, in general, be likely that the terms of exchange will be near to the middle point (which, in our particular instance, would be $10x$ to $17\frac{1}{2}y$), or, more accurately, to a position determined by an average obtained from the comparative costs of all the commodities exchanged between A and B.

One special case has not yet been discussed, and as it has supplied critics with a specious objection, it ought to be noticed here. Suppose that the country B, instead of being able to produce y at the amount of 15 per unit of productive power, is absolutely incapable of so doing, or can gain from its own resources only a very small amount, say $1y$ for each unit. How, it has been asked, are the terms of exchange to be settled? And further, is not the possibility of such a case an evidence of the erroneousness of the theory?[1] The answer to this very plausible objection is to be found in the express statement of an element which is implicitly contained in Mill's theory, viz. the limit set to exchange by the comparative utility of the

[1] See Cournot, *Théorie des Richesses*, pp. 344-345, for this objection. Like all the doctrines of that acute thinker, it deserves examination.

commodities x and y to the consumers in B. So long as the comparative costs of production were closer than the comparative utilities, there was no necessity for dwelling on this latter condition; that is to say, that so long as B could, from its own resources, obtain $15y$ for $10x$, there was no need to refer to the limit of utility, which, for an average amount, we shall assume to be $8y$ for $10x$. When, however, this power of producing at home the commodity required is withdrawn, the limit set by utility comes into operation, and it would furnish the really ultimate and complete limiting condition in cases of absolute monopoly on both sides.[1] It must, too, be added that utility varies with the quantity demanded, and that value is determined by the final or marginal utility, or the advantage to the consumer of the last increment obtained, so that in no respect does Cournot's criticism hold good.

The last step in turning our originally abstract and unreal hypothesis into an interpretation and illustration of international trade has now to be taken. Let us add to the two countries A and B a third country C, which is capable of producing the three commodities x, y, and z, but in which the ratios of

[1] This operation of utility is fully recognised by Mill. "The utility of a thing, in the estimation of a purchaser, is the extreme limit of its exchange value: higher the value cannot ascend."—*Principles*, iii. 2, § 1. In criticising the statement in the text, Professor Edgeworth (pp. 623-624) seems to have overlooked the particular passage in Cournot to which it is intended as a reply. Cournot urges that in the case of an article not producible in A, the advantage obtained would be *infinite*—"an exaggerated deduction which warrants us to distrust the theory." This contention seems satisfactorily encountered by reference to the limit set by the utility of the article to consumers, which may be small, and is never infinite.

exchange, resulting from the comparative effects of the productive agents, are $10x$, $14y$, and $80z$. From inspection it is plain that the most economical arrangement will be the production of y by A, of z by B, and of x by C; for the total production, when each country produces for itself, will be $30x + 49y + 270z$; whereas, when each country takes up the production of that commodity in which it possesses a relative advantage, the total becomes $30x + 60y + 270z$, thus giving a gain of $11y$. It is also a consequence of the comparative conditions of production that C is able to supply x on better terms to A than B, who has previously done so. Whether such will be the actual result, however, depends on the comparative intensity of the combined demand of A and B for x, as compared with the demand of C for y and z—a proposition which will also apply to the cases of A and B with regard to their respective products. The existence of two independent sources of supply for each of the commodities will, in addition, prevent the division of gain in any case being very much in favour of one of the parties. If, for instance, A and C were isolated from the rest of the world, $10x$ might conceivably exchange for almost $20y$; but the competition of B, who will find it expedient to withdraw from the production of z, in which it could, at the most, get $18y$ for $90z$, produced by the same sacrifice as it would cost to produce $10x$, will prevent such a result; so that the probable outcome would be the modification of any terms of exchange by which the advantages of the trade were very unequally divided.

A further consequence of great importance, and one which even popular doctrines on the subject fully

recognise, is the effect on the parties already trading of the introduction of a new country. Up to the present it has appeared that a country always gains by foreign trade: the sum of its wealth is increased, or, in any case, better distributed. The effect of an extra trading body coming into the field may be to remove some of these advantages. It is possible that the competition of C may not permit of B's obtaining such favourable terms in the exchange of its products x and z. Nay more, it is evident that C would, under the assumed conditions, force B to abandon the production of x, and to confine its efforts to the production of z, in regard to which it did not, so long as its foreign dealings were confined to A, possess the greatest comparative advantage. In fact, B would be undersold by C. It is, however, possible that the increased demand for the commodity z, which would be the natural consequence of the introduction of C, would, to some extent, compensate for the loss inflicted on B. Whether this would be the case or not, it remains certain that the total production would be increased, and thus that the other countries (and A in particular) would gain more than B had lost. When more than two nations are introduced, it is also evident that the exports and imports passing between any two of the nations need not be equal. In an extreme case it is conceivable that, with three countries, each might only receive commodities from one, and only send them to the other; thus A might send y to C, who sent x to B, who, in turn, sent z to A. The equality of imports and exports will only be found over the whole trade of any country. The sum of its imports must equal that of its exports. That is, of

course, assuming there are no other relations between it and other countries.[1]

Having introduced each of the elements which, in the original hypothesis, were removed for facility of reasoning, let us suppose that a number of "nations," A, B, C, D, etc., trade with one another in respect to a number of commodities, x, y, z, w, etc.: what will be the consequence? The analogy between international exchange and that between independent individuals has already been dwelt on.[2] In each case there is room for somewhat wide variations where but two parties are concerned.[3] When a number of individuals within any nation are engaged in trade, a market, using that term in its wider meaning, grows up, and the terms of exchange become more definite, so that we may say that commodities, when freely produced, tend to exchange in the ratios of their respective costs of production; but the influence of cost of production does not prevent some individuals from receiving large rewards for what are to them slight exertions, and which may even be a source of pleasure.[4] The gains which persons thus obtain by their special taste for an employment

[1] See Chap. IV. [2] See p. 13.

[3] In a tribe of savages, "if any exchanges took place between individuals within the community, they would obviously be governed, not by cost of production, but, like the exchange between Esau and Jacob, by the urgency of the respective needs of the parties."—Leslie, *Essays*, p. 181.

[4] "The laborious effort fitted to produce a given result does not represent the same sacrifice for different people: it is one thing for the strong, another for the weak; one for the trained workman, another for the raw beginner."—Cairnes, *Leading Principles*, p. 95.

Cp. Sidgwick, *Principles*, p. 58:—"In fact, when we consider the higher kinds of skilled labour, it must be evident that the labourer often gets more enjoyment out of his work than he does out of anything else in life."

which is usually regarded as onerous, are of the nature of rent, and deserve more attention than economists have been willing to bestow on them. In international trade similar phenomena are to be met with; but they have scarcely been noticed at all. The competition of different countries tends to establish a definite rate of exchange, and any aberrations from the terms thus settled are rectified by the play of reciprocal demand. The best evidence of the truth of this proposition is furnished by the exceptions which are found to exist. They all occur in the case of commodities produced in a single country, and even then are not always to be met with.

To rightly understand the nature of international trade, it is, above all things, necessary to constantly bear in mind its great complexity. The existence of numerous nations, in the economic sense, each the producer, actually or potentially, of many commodities—the fact that the cost of each of these commodities will vary according to the amount produced, sometimes increasing, sometimes diminishing, as the production is extended—the operation of customary conditions within each nation giving rise to groups possessing what are virtually qualified monopolies—the limiting effects of the various impediments to transport, as also the operation of local advantages within each nation, have all to receive full recognition in the theory of international trade, and have to be realised when seeking to interpret any special phenomenon. It is obvious that without the use of special hypotheses, it would be impossible to work out any theory on so intricate a subject.[1]

[1] Cournot, *Théorie des Richesses*, pp. 349-350, objects to the hypothetical procedure as adopted by Mill, and prefers to deal with

Some further considerations bearing on the theory of international values may most suitably be considered here. (1) It may have occurred to the reader, that all through the preceding discussion the powers of production of the supposed countries, A and B, have been regarded as being approximately equal in amount; and the objection naturally arises, Would this theory apply to the case of trade between a small country and a large one: to take a concrete instance, between the Isle of Man and England? On examination it appears that there is no failure of the elementary principle, which regards comparative intensity of demand as fixing value. The small country A, let us assume, will, by its demand for x, but slightly affect the total demand in the large country B, and there will not be any serious alteration in its value, since the amount of y which A brings into the market is, *ex hypothesi*, small in proportion to the total amount of y. It therefore follows that the production of both x and y will continue to be carried on in B, while A will give its entire efforts to the production of y, and will therefore obtain almost the entire gain of the trade. With different costs of production of y in B, it is probable that B will receive some advantage, since the production of the most costly part of y will be abandoned by it. It is hardly necessary to add that the competition of other nations would have a tendency to deprive A of this special advantage; but nevertheless the probability is, that a small country gains by opening up trade with a large one—a point of some practical importance.[1]

the complex problem; but his results are not encouraging. See Appendix B.

[1] The consideration noticed in the above paragraph has been

(2) The way in which the gain of each nation has been computed also stands in need of further elucidation. For convenience we assumed that each nation had two units of productive power, which were not necessarily of the same amount in each country, and we considered the distribution of the gain resulting from the readjustment of the industrial forces, so far as these selected units were concerned. In the actual working of foreign trade, it is the whole productive power of a country which undergoes alteration, and it is as the result of this readjustment that gain is obtained. It is therefore plain that the definite figure $5y$, which we adopted in the earliest form of our hypothesis, is merely illustrative, and that any quantitative estimate of the gain arising from international trade is not to be looked for. By altering the figures used for illustration, various divisions of the gain from trade may be arrived at; but then the differing results are obtained from altered *data*.[1] From the side of international value, the

developed in an interesting way by Professor Nicholson, *Principles of Political Economy*, vol. ii. pp. 302 *sq.*

[1] Cournot, *Théorie des Richesses*, p. 345, objects to Mill's theory, on the ground that by taking y instead of x as the common "denominator," or measure (see p. 24), the percentage of gain obtained by each party would be different. Thus, if instead of taking $10x$ or $15y$ in A, we suppose that a unit in A produces $13\frac{1}{3}x$ or $20y$, then on the hypothesis that the ratio of exchange after international trade is opened is $10x{:}18y$, Cournot argues that the percentages of gain to A and B will be $16\frac{2}{3}$ and $11\frac{1}{9}$ respectively, while if the original figures were retained the percentages would be 20 and 10, and adds that "mathematical questions do not admit of such ambiguities." His contention is regarded by Professor Edgeworth as "hitting an inaccuracy on a very plausible interpretation of Mill; on any interpretation an inelegancy" (*Economic Journal*, vol. iv. p. 624, cp. p. 609). It is, however, certain that the difficulty is entirely imaginary. As pointed out in the text, the particular figures are merely illustrative. The varying percentages which

general conclusion must be, that the advantage of foreign trade consists—first, in lowering the value of imported goods, as compared with those produced at home, or in limiting the gains of special groups of producers, to the advantage of the society in general; and, second, in permitting the productive power of a country to be employed in those commodities for which it is specially fitted. In the ordinary illustrations this twofold benefit is lumped up in the gain on the process of exchange; but a not uncommon instance will bring the two elements into light. Suppose an improvement in the production of the commodity x to take place in B, so that $12x$ will be produced by a unit of labour, this, of itself, would tend to lower the value of x, as measured in terms of y; but since it is the readjustment of industry resulting from foreign trade that has made it possible for x to be more cheaply produced, it follows that the gain of B will be obtained by that extra efficiency, while it is probable that some of the advantage will be retained in exchanging x for y, so that a double element of gain will be present. The nature of the commodities exchanged, and the extensibility of the demand for them, are in this latter case the determining conditions. The operation of the laws of increasing or

Cournot obtains are due to the illegitimate changes which he makes in the units employed. In the original illustration he estimates the percentage by taking the produce of the less efficient unit in A (15) and that of the more efficient unit in B (20); in the second and altered one he takes the produce of the more efficient unit in A (13½) and that of the less efficient unit in B (10). As a necessary result different percentages are obtained. A more natural method would be to calculate the amount of gain by taking the total result of the two productive units in each country, reducing the two commodities to a common measure, by which process precisely the same percentages would be obtained in either case.

diminishing return, as the case may be, also affects the question; if the commodities which a country imports are not subject to the latter law in the country from which they are obtained, but would be if produced at home, the country will gain considerably by the existence of a trade which prevents one set of the articles which it consumes from being produced at a constantly increasing cost. Should it happen that the law of increasing return is applicable to the production of the country's exports, it gains by the continuous augmentation of its industrial efficiency. The present position of England in respect to its foreign trade is somewhat of this kind; so that we might say, *a priori*, that her gains from commercial intercourse would be peculiarly large; and the evidence of statistics seems to verify this deduction.

(3) The effects of impediments to exchange on the course of trade is also deserving of some further notice. Among these impediments may be placed—(*a*) actual cost of carriage, such as shipping freights and railway charges; (*b*) brokers' and agents' commissions; and (*c*) import and export duties, whatever be their aim. With respect to the first of these deductions from the total gain, the important fact specially emphasised by Sidgwick, that transport is a double operation, is fundamental. The import has to be brought in, and the payment for it sent back; and, as the aim of men, regarded as traders, is to reduce all the expenses incurred to obtain a given object, it follows that every effort will be made to diminish this cost of transfer. Another interesting point is the costliness of the very agents of transport. Ships and trains—to take the two most prominent agents—are not

moved without difficulty, and therefore it is desirable to find profitable employment for them both on their outward and return journeys. The course of trade is often determined by the possibility of finding a return cargo; and instances may even be found of the creation of an industry for this purpose.[1]

No better illustration of the actual working of the abstract principles which have been considered in the present chapter, can be found than the way in which the cost of the double journey is divided in the case of the English coal exports, so thoroughly investigated by Jevons.[2] Those places which have no return cargo to furnish are compelled to pay the total cost of the two voyages; their exports in payment being, as we shall see, adjusted by means of the foreign exchanges. The effect of commissions is, of course, the same as that of freights; but it must be remembered, that the rate of profit expected by a trader is that to be obtained in the country where he resides, and, owing to the generally hazardous character of foreign trading, will naturally be even higher, so that it is probable that a country with a low rate of interest will be at an advantage in engaging in the carrying trade.

German writers, and Mangoldt in particular, have laid stress on the distinction between "active" and "passive" nations, *i.e.* between those that carry on foreign commerce themselves, and those that simply admit traders from other countries. Such a distinction belongs rather to the historical development of commerce than to the abstract theory. It is of course

[1] The Glasgow potteries mentioned by Hearn (*Plutology*, p. 310) are a case in point.

[2] *Coal Question*, chap. xiii.

plain that the traders of the "active" country have at first an opportunity for special gain, since they will avail themselves of any advantages that the conditions of a passive country afford (p. 68). In time, however, this "opportunity" gain disappears and is replaced by the usual interest on enterprises of the same class, and the equally normal profits of the undertaker or *entrepreneur*.

The effect of duties, whether imposed for revenue or "protection," is so important as to need discussion in a separate chapter; before, however, touching on questions of practical policy, we must deal with an element, of which, up to the present, no mention has been made, but which has been the cause of most of the difficulties of the subject.

CHAPTER III

MONEY IN INTERNATIONAL TRADE

INTERNATIONAL trade has, in the preceding chapters, been studied in its broadest and most general features. It has been regarded as being in form what it is in substance—the interchange of commodities. It is, however, only in the case of primitive communities that this direct interchange is to be found. To get a clear idea of such a state of things, it is necessary to go back to our Homer and Herodotus, or to take up the works of writers on Ethnology.[1] But the modern system of international trade, with its widely extended ramifications, though, in appearance, very unlike the rude and clumsily-managed bartering of the old Hellenes, or the surviving Australian tribes, is, nevertheless, fundamentally the same. The only difference is to be found in the presence of money in the former, as an agent for smoothing and assisting the process of exchange.

To those who are acquainted with monetary theory,[2]

[1] See the well-known passage in the *Iliad*, vii. 467-475. And cp. the opening chapter of Herodotus. For instances of intertribal bartering among modern savages, see Tylor, *Anthropology*, pp. 281-282.

[2] For the theory of money see J. S. Nicholson, *Money*, part i.; F. A. Walker, *Money*. Reference may also be made to the article "Money," by the present writer, in the *Encyclopædia Britannica* (9th ed.), vol. xvi. pp. 720-738; for its early history, *ibid.* p. 722.

it will not be hard to prove that in international, as in domestic, trade, money is but one of many commodities, and has to be so regarded. An examination of the course of its development confirms this view, which is established by an analysis of its principal functions. Granting however freely, that the circulating medium is simply a commodity, still its peculiar qualities, and the work which it has to discharge, make it essential for a right treatment of the topic of foreign trade to understand thoroughly its position in the actual course of international exchange. To put the problem in another way: as yet we have only considered international values; it is now requisite to investigate the conditions governing international prices.

As a clue to the line of inquiry, let us remember that, in its beginnings, international trade uses only a rudimentary form of money, in the shape of some specially prized article or articles, and that in the course of development it is very hard to fix upon the exact time at which a currency properly so called becomes established; so that it may be surmised that the introduction of a common medium of exchange is not likely to alter the general laws which regulate value. The copper, silver, or gold which is, at earlier stages of a nation's existence, received for its use in industry or ornament, retains to the last the character which it had at its introduction. There are, however, some consequences resulting from the very functions of a circulating medium, which, by their effect on the conditions of supply and demand, do, in some degree, make the position of the money-material anomalous. The law of demand for an ordinary commodity is of

an irregular kind. It is indeed possible to group commodities, and to state general laws as to the variations of demand for necessaries, decencies, and luxuries;[1] but all such formulæ are empirical, and can never pretend to much accuracy. As, however, the value of money, *cæteris paribus*, varies inversely as its quantity, the law of demand is, in its case, perfectly regular, since it is the quantity of money that determines the range of prices, and is, therefore, the really important element. It is true that the money-material may be used in various arts and industries; but for our present purpose it is admissible to neglect this portion, regarding it as merely a potential source of supply. The course of economic development has established gold and silver as the chief—in civilised countries it may be said the only—forms of money-material; it will, therefore, for the future, be convenient to recognise their special position, and to speak of the "precious metals" or of "bullion" as being equivalent to "money-material"—a term which will also be used.

The precious metals, then, whether produced in a country, or imported, will come under the conditions regulating international values, since, owing to the very qualities which have given them their position, and particularly their portability, they are, and always have been, specially suited for being the subject of foreign trade.[2] Another circumstance of some importance is the mode of their production (in general, by mining), which makes the law of diminishing return

[1] See Jevons, *Theory*, etc., pp. 161-172; also Professor Marshall's discussion of the construction of "demand schedules" in *Principles* (4th ed.), book iii. chaps. iii. iv.

[2] See Marshall, *Principles*, book v. chap. i.

applicable to them; so that, in accordance with the principle stated above (p. 29), it is very probable that they will be produced in different countries, and will not be monopolised by any one nation. The amount of the total annual production is, moreover, very uncertain, and is largely affected by chance, from which, as might naturally be expected, it results that the amounts obtained at different periods vary widely. Finally, the extraordinary durability of both metals has led to the accumulation of a very large store, in comparison with which the variations in amount of production during short periods are quite insignificant.

These patent facts lead directly to some important inferences. If the money-material is durable, if a large stock of it is in existence, and if the quantity of it in a country is a principal factor in determining the scale of prices in that country, it follows that bullion will be a very convenient form of import, or export, as the case may be, since it will never be unsaleable, and can be retained without deterioration.[1] When any particular case of international exchange is being carried out, the precious metals will naturally be used as a means of adjusting any discrepancies in the equation of exchange; but in such cases gold and silver, though discharging a highly useful function, would still be nothing more than peculiarly desirable commodities. As yet we have not openly abandoned the hypothesis that barter exists in domestic as well as in international trade, or, at all events, that a standard of value has not been evolved. It will now be convenient, as well as

[1] "Money is never second-hand; it will always fetch itself, and it loses nothing by keeping."—Bagehot, *Economic Studies*, pp. 58-59.

legitimate, to regard money as being fully established for the purposes of internal trade. It at once follows that bullion, which, allowance being made for seigniorage and mint charges, is convertible into coin, will not only be a specially prized commodity, but also a mode of legally discharging all obligations incurred; so that the terms of international exchanges will be settled in terms of money, and any balance lying over after a series of mercantile transactions, can be removed by the transmission of money from the debtor to the creditor country. How will the state of trade between the two countries be affected by such transactions? It is a necessary deduction from elementary principles already stated, that the transfer of a portion of the precious metals will tend to lower the value of money in the receiving country, and to raise it in the transmitting one. The very fact of transmission will, moreover, show that, the precious metals apart, the equation of international demand is not established between the two countries, and, therefore, that international values need readjustment. Should, however, the effect produced by a single transmission of bullion not suffice to bring about the required alteration, it is evident that the forces which produced the first movement will remain in operation, and that, in fact, a drain of money will continue until the terms of international exchange become such as will establish the necessary equation; an effect produced, be it noted, by the movement of money from one country to the other, having, as its consequence, the lowering of prices in the former, and their elevation in the latter. It therefore appears that when money is introduced in domestic trade, it will be utilised as a ready agent for remedying

any break in the equation of international demand; and further, that by alterations of its quantity, it will powerfully affect the scale of prices in each country. It may, too, be added, that smaller or larger amounts of the money-material are continually passing from country to country, in consequence of the various changes in the conditions governing international exchange.

It may now be asked, What would be the state of things in which no passage of money would be required? As there is always expense and risk attending the carriage of even gold and silver bullion, it is clear that the interest of dealers would lead to an effort to attain that condition. Since bullion is used only to remove balances incurred in the course of international trade, owing to the non-existence of the equation of demand, the establishment of that equation is the condition required to save the cost of transmission, and there is therefore a force always in operation tending to produce that result. The equation of international demand can only be maintained through the due adjustment of values in each of the countries concerned; but when money is fully established, so far as internal trade is concerned, values will be estimated in it; it follows that to alter values it is necessary to act on prices; but a change in prices is equivalent to a change in the value of money, and as the value of money is, in a great degree, determined by its quantity, it follows that where the equation of international demand is not established, the most obvious mode of remedying such a state of things is by the transmission of bullion, which will cease when that equation is attained. It may, therefore, be said that the equation

of international demand, which was, as we saw in the last chapter, the outcome of the natural conditions, assuming a state of barter, is also the condition of equilibrium, when money is introduced, and thus we may at once state Ricardo's greatest contribution to the theory of international trade in his own words:—

"Gold and silver having been chosen for the general medium of circulation, they are, by the competition of commerce, distributed in such proportions amongst the different countries of the world as to accommodate themselves to the natural traffic which would take place if no such metals existed, and the trade between countries were purely a trade of barter." [1]

The proof of this fundamental principle is, it may be remarked, the same in form as that of the cost of production theory of value given by Adam Smith.[2] In both cases it is shown that there is one definite condition of stable equilibrium to which, even when it is departed from for a time, there is a tendency to return —a tendency which makes all other possible conditions necessarily unstable. An easier, but less satisfactory, line of proof is suggested by dwelling on the fact that money is merely a common denominator of values, which does not itself affect them; and since things which are equal to the same thing are equal to one another, the values of articles exchanged for each other by the intervention of money will necessarily be equal.

[1] *Works*, pp. 77-78. Mill (iii. 21, § 2) declares that Ricardo was the "real originator" of this doctrine. Its germs are to be found in his *Higher Price of Bullion* (1809), where reference is made to "the most approved writers on Political Economy."—*Works*, p. 263.

[2] "The natural price, therefore, is, as it were, the central price to which the prices of all commodities are continually gravitating."—*Wealth of Nations*, p. 24*a*.

Ricardo's theorem—to which he has a much better right to give his name than to the so-called Ricardian theory of rent—however, implies much more than the mere fact that the use of money as a medium of exchange and a measure of value does not alter the fundamental laws of value. It is not merely a vindication of the legitimacy of treating international trade as if it were a trade of barter, not a mere exclusion of certain possible influences; it has also a positive side. It contains a definite statement as to the law which governs the distribution of money in the world's trade, and thus furnishes a guide for working out that part of our subject. The total stock of money-material must be divided in such a way as to keep up that state of trade which would exist under a pure barter-system. Since, however, money produces its effect through prices, this is equivalent to the assertion that prices must be so adjusted as to bring about the desired results. How is this to be accomplished? Evidently by establishing a scale of prices such as will allow the operation of those exchanges which follow from the condition of comparative cost. Comparative prices must be such as to, in some cases, make a country import what it could produce with less cost, or export what it has not the greatest facility for producing. They must, too, permit of the maintenance of the equation of international demand, as resulting from the comparative intensity of need on each side. There are still other conditions to be conformed to. They must allow the modifying effects of the laws of diminishing and increasing return to have their due weight, as also the retarding influence of all the impediments to international exchange; and finally, where competi-

tion fails, they must represent the working of reciprocal demand within the several "nations." How, it may well be asked, can these numerous and complicated demands be met? The answer is best given by making use for the moment of a provisional abstraction. Let it be assumed that prices in a country are governed wholly, instead of partially, by the quantity of money, and that rapidity of circulation, the varying activity of trade, and the movements of credit, have no influence. Then, to establish any needed scale of prices, it is only necessary to alter the amount of money-material. Thus each of the conditions we have stated may be satisfied by this expedient. To cause a country to import what it could produce with less effort, it is sufficient to raise prices in that country, so that the commodity in question becomes of higher price when produced at home than when imported. To cause a country to export what it has not specially great technical power to produce, prices must be altered within the country, while the price of the special commodity, as compared with other articles, is depressed; and similar considerations apply to all the other cases.

The gains of foreign trade which, when regarding them as obtained through barter, we stated in terms of the products exchanged, may now be estimated as realised by means of a higher scale of prices. But from either point of view the same result is ultimately reached, though the process is in appearance very different, since, in the former case, we had to assume that "higgling of the market"—the offer on each side of certain ratios of exchange—which, by the play of desires on each side, were settled in a definite way—a

process replaced, in the latter case, by the smooth and almost automatic working of exchanges with duly-adjusted prices.

In order to test the validity of the results just stated, let us see in what the gains of international trade consist, when looked at from our new standpoint. One evident advantage is the comparatively low price of imported goods[1]—an advantage which, from the side of barter, was represented by their lower value; the other advantage which we found existed when barter was the form of trade—the increased efficiency of the productive agents—is now represented probably in higher money wages and profits; but, whether this be so or not, always and necessarily in higher real wages and profits. The nature and amount of the gain are finally to be summed up in the phrase, "increase of utility," which, however its component elements may be analysed, is the general expression for the advantage derived from all exchange.

Another consequence of the new form of international trade is to be noticed in respect to cost of carriage, and, indeed, all impediments to exchange. Since prices, not values, are now the condition to be attended to, it is clear that the price of an article, in any country, cannot exceed its price in any other by more than the sum of the impediments to transfer estimated in money, and that in the case of an imported article it will exceed it by that amount. Therefore, as regards portable articles, the difference

[1] Not necessarily lower price, since the result of foreign trade may be to raise the prices of all commodities higher than they were before the trade was opened.

of price in different countries cannot be very great, and the influence of cost of carriage, as an impediment to trade, will work mainly through the alteration of the scales of prices in the various countries.

There are some special cases which will further confirm and illustrate the principles laid down. In accordance with the usual form of exposition, as well as with the facts of trade in general, we have hitherto spoken of the money-material, and regarded gold and silver as being both used for currency.[1] But we may also take a particular case where gold is used by itself in one country, silver alone in the other, the second metal in each case being merely a commodity. At first sight, it would appear that the trade will be one of barter, even in form; but closer observation shows that—prices in each country being regulated by the quantity of the metal used as currency in that country—the only place for barter is in settling the ratio between gold and silver. If it is such as to preserve the equation of international demand, no change will be required. Should this, however, not be the case, an alteration of prices will be needed, which would normally be produced by a passage of money from one country to the other; but as in the present instance this is impossible, the adjustment will be reached by

[1] Professor Nicholson (*Money*, 5th ed. p. 372) has forcibly urged that "in discussing the question of the effects of money on international trade the old theory constantly takes 'the precious metals' as a unit." It is possible that Mill held this view, but there is evidence to show that Ricardo did not. He points out that there cannot be a fixed and invariable par between gold and silver, and he declares that the ratio had lately changed from $14\frac{3}{4}:1$ to $15\frac{1}{2}:1$. He actually gives as one of his reasons for preferring silver to gold as the standard that all other countries used it; see his *Works*, pp. 272, 274, 311, 403.

other means. The failure of the equation will leave a balance to be paid by the debtor country, which can easily be done by procuring a sufficient amount of the currency of the creditor country; the demand for this commodity will produce a rise in its value as measured in the debtor country's currency, that is, an alteration in the ratio hitherto existing between gold and silver. The effect will be to alter all gold prices as measured in silver, as well as all silver prices measured in gold —a change equivalent to an alteration in the comparative prices of the two countries—by which process a state of equilibrium will be produced.[1]

The trade between such countries as England and India (before 1893), or China, supposing them to be separated from all other nations, would conform to these conditions. If, as was till recently the case, other countries existed with stocks of gold and silver, obtainable at a fixed ratio, then, as long as either metal could be procured, it would be purchased, and transmitted to the creditor country, when it would tend to restore equilibrium by raising prices. England, it need hardly be said, has freely used the silver possessed by France, in order to conduct its trade with Eastern countries.

The foregoing considerations will help us in dealing with another class of cases which might be supposed to present some difficulty, viz. where the circulating medium of one of the nations is affected by a seigniorage, either equivalent to the cost of minting, or for any greater amount. In this case the debased

[1] See Professor Marshall's masterly "Memorandum" on the effect of different currencies on international trade, *Appendix to Final Report* of the "Gold and Silver Commission," pp. 47 *sq.*; and for a different view, Nicholson, *Principles*, book iii. chap. xvii. (vol. ii. pp. 140-147).

currency is in practice a different commodity, and therefore the mode of producing equilibrium will be by the movement of "bullion," which will, in general, command a premium, as compared with the inferior currency, owing to its higher value for purposes of foreign trade. Nothing but limitation of the quantity of debased coinage can prevent the appearance of this premium; but usually limitation is effectual for the purpose, and if free minting be not allowed, it is even possible that the debased currency would itself command a premium as being the only legal mode of discharging obligations in the country where it circulates. The operation of seigniorage, when merely sufficient to cover the cost of coinage, resembles a duty on the importation of money-material, and is so far an impediment to the process of international exchange: it is analogous to dock dues and charges on the importation of commodities, and is thus quite unobjectionable.

The topic of seigniorage naturally suggests the further question of inconvertible paper-issues. They, as Ricardo has acutely observed,[1] "are pieces of money on which the seigniorage is enormous." It will, therefore, be admissible to adopt the course we have followed when dealing with debased currencies, and treat the paper circulation as a new commodity turned into money. So long as the precious metals continue in circulation, it is obvious that they will discharge the functions of money so far as foreign trade is concerned; and it is only on their complete disappearance that the adjustment of international exchange will be carried on, not by a passage of

[1] *Works*, p. 345; cp. p. 213.

money, but by an alteration in the ratio between paper and the precious metals.

The preceding cases possess one feature in common, for they all imply the existence of different standards in the several nations engaged in trading. And for this condition of things a general principle may be laid down. It is—*That where adjustment of prices by the passage of money is impossible, it can only be produced by an alteration in the ratio hitherto subsisting between the currencies in question.* Exceptions to this principle will only be found where the fact on which it rests does not operate, that is to say, where the money of one or each of the countries is acceptable as a commodity in the other, and there is, therefore, room for a limited transfer of money-material.

The case of inconvertible paper currencies leads up to a modification of the assumption that we made when commencing this part of our inquiry, viz. that the value of money depended solely on its quantity. Though it is indeed one element in determining the value of money, there are other conditions to be taken into account. These briefly enumerated are as follows:—1st. The extent to which barter is used in trade, and thus obviates the need of money. 2nd. The employment of the precious metals for non-monetary purposes. 3rd. What has been styled "the efficiency of money," or the average amount of work done by each coin. 4th. The operation of paper money, which, in fact, is nearly akin to the second head, since the issue of notes against a smaller metallic reserve is a mode of increasing the efficiency of that reserve. 5th. The use of credit in its various forms, which is really a refined kind of barter. 6th. And lastly,

the amount of transactions, as it also affects the scale of prices, or, what is the same thing, the value of money. But these varied elements, though they help to obscure and complicate the real problem, do not, on analysis, overthrow the elementary principle which connects the value of money with its quantity. Even where exchange in kind widely prevails—that state of "barter economy" (*Naturalwirthschaft*) on which the German historical school is fond of dwelling—the circulating medium, once introduced, gains a powerful influence on all market prices, and necessarily an alteration in its quantity affects them proportionally, though it may not touch the great mass of customary transactions.[1] For the period of "money-economy," it is admitted that changes in the quantity of the circulating medium speedily affect prices. But at first sight it does not appear so easy to extend the proposition to the fully developed period of "credit-economy." Here the operating conditions are so many, and the complex organisation of industry presents such difficulties to the investigator, that there is some excuse for thinking that the influence of the quantity of money has ceased to be powerful. It can, however, be proved that the effect of quantity of money on prices is as potent as ever. Take the developed English system: will not the quantity of the precious metals affect it? Manifestly it will, and in the following way:—Retail prices are affected by the quantity of gold and bank notes; but the former is actually some of the money in question,

[1] For an admirable study on the movements of prices, and the contrasts between commercial and stationary districts, see Leslie, *Essays* (2nd ed.), No 19, especially pp. 269-277.

while the notes are representative of it, and connected with its amount through the operation of the Bank Charter Act of 1844. Turning to the elements of (1) credit, and (2) the amount of transactions, is there not a connection between them both, and further, are they not powerfully affected by the market rate of discount? The most potent factor in determining the market rate of discount is, however, the banking reserve, which is itself connected with the metallic reserve; so that in fine we come back to the quantity of money, *i.e.* precious metals, as the underlying power which more than anything else tends to change prices.[1]

The existence of different forms of economic organisation, though it does not prevent the quantity of money from affecting prices, produces other important effects on the distribution of the precious metals. The Ricardian law states the way in which the total amount of the precious metals is distributed among the several nations of the earth, and it points out the conditions which determine that distribution. It is

[1] The connection briefly explained in the text has been worked out by Sir R. Giffen, who carefully distinguishes between "simple" and "complex" industrial systems.—*Essays in Finance* (2nd Series), No. 2, pp. 37-88. A friendly critic (Professor J. B. Clark, *Political Science Quarterly*, vol. ii. p. 525) suggests that it is unjustifiable to assume that the special English method would hold good elsewhere. But though the precise mechanism may vary from country to country, it seems indisputable that under any system of "credit-economy" there must be a mode of restoring equilibrium. The agency may be represented by a Government department (the United States Treasury might act in this way), a privileged bank, or an association of private banking companies, but whatever the form, the principle in operation is the same. It need hardly be said that the effectiveness of the organisation will vary from country to country.

necessary, as we have seen, to preserve the equation of international demand, since any other position is unstable; and this result is obtained by adjusting the comparative prices of the different countries, which, in a simple industrial system, is only possible by changing the amount of money. When the further influences of credit and varying efficiency of currency come into operation, the desired adjustment may be obtained by their means. Thus, an issue of paper-money may raise prices at a time when that change is needed, owing to the position of international trade; and the nation which is able to adopt this course escapes the loss which is incurred by importing a given amount of bullion. The influence of speculative credit in raising prices, entirely apart from any increase of the stock of money-material, is well known, and discharges a similar function (as may also increased rapidity of circulation).

The result of these rather obvious facts may be more explicitly stated as follows. The distribution of the precious metals should, speaking broadly, be regarded as the result of two conditions. 1st. The state of international exchange, which requires the allotment to each country of an amount sufficient to maintain the position of stable equilibrium; and this being so settled — 2nd. The various factors which determine the range of general prices. It is impossible to estimate the quantity of money required by a nation without taking both classes of facts into account.

We see, moreover, that alterations in the internal economy of a nation will produce effects on international exchange, and will render a redistribution of the money-material necessary. The adoption of an

inconvertible paper currency by a country will send a quantity of the precious metals out of that country to be distributed amongst the other nations of the world. Improved banking arrangements, the use of representative money, and all other economising expedients, will have a like effect. The substitution of money-exchange for the process of direct barter, and the increase of trade, will lead to an opposite result. An interesting deduction may be noticed here. It is evident that banks, and all such organisations, regarded from the international point of view, perform a useful office, in enabling a country to maintain its proper scale of prices with a smaller quantity of money than would otherwise be required, and thus confer a benefit on the country in which they exist.[1]

The causes which affect the distribution of money through the various nations are so many, and so likely to vary from time to time, that it is almost certain, *a priori*, that there will be a nearly continuous series of movements of bullion from country to country—a proposition which is amply confirmed by experience. In particular, one cause for such changes should be emphasised. The quantity of money-material, even if fixed in amount and indestructible, would be redistributed, owing to the conditions above stated; but money is being slowly worn out, and is also being continually produced in greater or less abundance; and it is therefore essential to replace the loss taking place in countries which do not produce the precious metals, as also to withdraw their superfluous stores

[1] "The judicious operations of banking . . . provide . . . a sort of waggon-way through the air."—*Wealth of Nations*, pp. 131, 132.

from the producing countries. The movements of bullion may then be grouped under two classes—(1) The frequent transitory movements which take place from country to country to correct slight fluctuations of price which are not needed by the state of foreign trade, and (2) the slower but larger movement from the producing to the non-producing countries. The fact that the quantity of money is itself variable, does not in anywise alter the conditions which we have found operative when that feature was disregarded. The distribution of new supplies is carried on under the same laws as a redistribution of the already existing stock would be.[1]

The whole theory which has just been worked out, is based on one assumption which has not in general been noticed by its propounders. It is thought to be unquestionable that a movement of the precious metals, or an alteration of the ratio hitherto subsisting between different currencies, will cause a change in prices, that is to say, that the economic system will alter when the conditions affecting it are altered, which is equivalent to assuming the existence of competition; and for most actual nations this assumption is amply justified. Let us suppose, however, that all prices are regulated by custom, and that an addition to the stock of bullion will not raise prices, but rather reduce the efficiency of money, and let us see how Ricardo's principle will be affected.

There are different cases possible, for—1st, the prices fixed by custom may be lower than they would

[1] See, for full investigation of the distribution of new supplies of gold, J. E. Cairnes, *Essays in Political Economy*, pp. 1-165, especially Essay III. (pp. 77-108); also Leslie, *Essays*, pp. 269-383.

be under competition; it will then be the interest of other countries to trade with the supposed nation, and to send to it their money, which, *ex hypothesi*, commands a higher value there than elsewhere; but as no alteration of prices takes place, the trade will continue, and be exceptionally profitable to the countries thus sending money. If the other countries possess a highly developed credit system, and if there be a considerable fresh annual supply of the precious metals, it seems as if this state of things would continue until the customary prices had given way before the development of industry and the constant influx of money. 2nd. Should the customary prices be higher than the competitive ones would be, it is clear that the countries possessing the competitive form of organisation will not import goods at a loss. They will, however, export at considerable advantage, and may thus cause a drain of money which will so raise their prices as to restore equilibrium. The general result is, that the competitive system is far more advantageous, from the international point of view, since it enables a country to rapidly adjust its prices so as to preserve its international position. The use of a large and increasing quantity of the precious metals for the purpose of ornament, would, especially when combined with the customary state, produce the disadvantageous result above described. And it is further evident that the release of a quantity of gold and silver, whether hoarded or used as ornament, is equivalent to an equal addition to the quantity of money, and will produce similar effects on the course of international exchange.

The consequence of this partial failure of Ricardo's

law may, perhaps, be illustrated in the case of India. The large amount of the precious metals, especially silver, absorbed by that country has been always a subject of remark. In recent years the change in the value of silver has led to an increase in the amount transmitted; but little effect has as yet been produced on Indian prices—a circumstance which has much increased the difficulties of the Indian Government, and has been a puzzle to writers on the subject. The partial existence of customary prices in India, combined with the use of increased stocks of the precious metals, for the purpose of ornament or hoarding, would satisfactorily account for the actual state of things, and it is possible that such may be the real explanation.

There remains one part of the relations of money in international trade which has not yet been investigated—viz. the cost of obtaining it, and the consequences resulting from that cost. In a gold-producing nation, it is plain that the total cost of money is to be measured by the amount of productive power which must be applied to obtain the amount of the precious metals employed for currency purposes in that nation; while, in all non-gold-producing countries, the cost will be measured by the cost of the commodities exported in payment for the needed amount of money-material. The conditions, therefore, which determine the cost of a nation's money are three in number; or, to use the mathematical expression which Mill has employed, the cost of money is a function of three variables, viz.—(1) The amount of money required by a nation, which, as we have seen, depends on the economic system of the country. (2) The state of

reciprocal demand. If the products of the nation are much sought after, the terms of exchange will be more favourable to it, and if its demand for foreign products is intense, they will be less favourable. The terms fixed by reciprocal demand are not, in actual trade, the same in both countries, owing to the influence of impediments to transfer; in estimating, therefore, the force of this condition, we must take into account the amount of the impediments, which will mainly consist in cost of carriage of bullion and of the exchanged commodities, but also in part of duties, imposed either on imports or exports; so that if a country be close to the place whence it draws its supply of money, and if the articles it sends out, or returns, be of high value in proportion to their bulk, there will be room for great gain by exchange, and the possibility of getting money cheaper; but the actual attainment of this result will depend on the state of reciprocal demand. (3) The positive efficiency of industry, which, if great, allows of the acquisition of a larger stock of money by a given effort, or a given amount by a less effort. The conclusion may, therefore, be drawn, that a nation obtains its money at less cost in proportion as these conditions are favourable to it; and we can again assert that all improvements in the monetary and credit organisation are for the national advantage. The second condition shows that the opening up of demand for a country's products will tend to reduce the cost of its money, as of all its other imports, and the removal, whether total or partial, of impediments to exchange will have a like effect. Increase in industrial efficiency will, too, enable a nation to procure its imports with less effort, and will, therefore, be advan-

tageous in enabling it to get its money-material with less sacrifice.[1]

The scale of prices existing in any country is, as we have seen, the result of well-defined causes, and cannot be altered by any slight force; but in the light of the preceding results, it may be well to see in what way a nation's interest is connected with the range of its general prices. High or low prices, all the world over, are, it need scarcely be said, of no consequence. They imply simply the existence of a greater or less number of counters. But one country, by having higher prices than others, may gain through its foreign trade, by purchasing its imports at lower prices, and by giving a smaller amount of exports in return. It is, however, impossible that such a position could be retained unless the international relations of the country permitted it, so that high general prices must be the outcome of favouring circumstances. The divergence of prices in different countries is, moreover, limited, since imported articles cannot be permanently higher in price than in the country of their production by more than the cost of the sum of impediments to exchange. It is, therefore, in articles whose transport is difficult or impossible, or in those subject to heavy import duties, that a great difference in price may be anticipated; and then, where the other industries possess greater productive power, it is probable that this feature will appear; but such high prices are an indication of industrial inferiority in certain branches of production, and cannot be regarded as advantageous:

[1] See, for fuller discussion of this point, Senior, *Three Lectures on the Cost of obtaining Money*, No. I.; Mill, *Principles*, iii. 19, § 2; and Cairnes, *Leading Principles*, pp. 489 *sq.*

and thus we may accept Cairnes' statement, that "what a country is interested in, is not in having its prices high or low, but in having its gold cheap, understanding by cheapness not low value, but *low cost.*"[1] The gain from international exchange will, indeed, be realised in all cases in the way explained before, viz. in reduced values of imports, and in the increase of wealth as proved by a rise in real wages and in the mass of profit.

[1] *Leading Principles*, p. 494.

CHAPTER IV

THE EQUATION OF INDEBTEDNESS

THE mutual relations of nations, or trading groups, are not all comprised in the actual exchange of commodities. When intercourse is of long standing, and when it has become possible to move capital with comparative ease from country to country, the exports and imports become but one element—a very important one, it is true—in the sum of commercial transactions. In order to understand the exact position of a country, we must consider not merely the equation of reciprocal demand, but rather what may be styled the equation of indebtedness. It is not the equivalence of imports with exports that constitutes the stable condition of trade, but the equivalence in the sum of debts due to the country, and that of debts due by it. The process of estimating a country's relations is not therefore so simple as the Mercantilist theorists supposed. They judged the balance of trade to be favourable or unfavourable in proportion as the exports exceeded, or fell short of, the imports. Even from their point of view, it was the balance of indebtedness which should have been taken into account, though it would not furnish a logical basis for the particular conclusion which they

sought to draw from the course of trade.[1] It is therefore requisite to clearly understand the nature of the different components of the equation of indebtedness. This investigation is, in reality, nothing else than stating the various parts of the debtor and creditor account of a country, which may perhaps be best arranged in the following order:—(1) It is desirable to give the first place to what the earlier writers regarded as the sole contents of this balance-sheet, viz. the imports and exports. A country is clearly a debtor to other countries by the value of all its imports, as, on the other hand, it is obviously a creditor by the value of its exports. (2) Next to imports and exports, we have to set down to the account the loans which a country receives or gives. The contracting of a loan by a nation makes the nations which offer the loan its debtors for the time being, till the loan is carried out, and it necessarily becomes their creditor. To take the most usual instance, investments of capital abroad, while being carried on, make a country a debtor, as the investment of foreign capital in a country makes it a creditor. (3) The annual interest on capital already invested acts in the opposite direction; here the investing country is a creditor, and the country which has previously borrowed a debtor. Both this and the foregoing elements are instructively illustrated by the relations of England with the United States

[1] Sir James Steuart notices "that there is a great difference between the wrong *balance of trade* and the general *balance of payments*" (*Works*, iii. p. 216), but fails to develop the conception. The expression "balance of indebtedness" appears to have been first used by J. L. Foster, in his useful pamphlet on *The Principle of Commercial Exchanges* (Dublin, 1804). By means of the conception that it represents, he exposes some common fallacies.

and her own Colonies. (4) The repayment of a loan previously incurred acts in the same way as the interest to be paid on it while outstanding. It comes to the credit of the receiving, and to the debit of the repaying country; which merely amounts to the assertion that the reversal of a process will in general have an opposite effect to the original process. (5) The next element is a minor one as compared with those that we have been considering, but still its aggregate amount cannot be neglected; it includes the earnings of native merchants living abroad, and the profits of foreigners residing in the country, that is, of course, so far as they are transmitted to their native country. In the former case the country is a creditor; in the latter, it is a debtor. (6) It is perhaps scarcely necessary to separate our sixth case from the last one. It occurs when foreigners transmit money for benevolent purposes to a country, or in the reverse instance of a country sending donations abroad—*e.g.* the annual remittances of the large number of Irish persons, who are naturalised in the United States, to the United Kingdom, amount to a considerable sum.

(7) Our next head will be more important. A country is a creditor for services done by its ships and traders. Though this head may, in some instances, touch closely on No. 5, still there is a shade of difference. The ships which a country employs in carrying for foreigners are in reality, as Sir R. Giffen has aptly called them, an "invisible export," and might almost, did the nature of statistical returns permit, be classed under the first head. On the other side, of course, a country is debtor for the services done by foreign ships and traders for it. When we remember that seventy

millions may reasonably be assigned as the annual amount of England's gain in this way, the importance of the item will not be disputed.[1] (8) The expenditure of a nation's Government abroad will also make it a debtor to that amount, and, conversely, the expenditure of other Governments in a country will put it so far in the position of a creditor. (9) An item of greater relative weight formerly than it is at present should not be left unnoticed, viz. tributes, or indemnities, due by one country to another. The paying country is here the debtor, and the receiving country the creditor. Striking modern instances are to be found in the case of the great war indemnity paid by France to Germany, after the war of 1870-71, amounting to £200,000,000, and in the indemnity from China to Japan. And finally (10), the expenditure of citizens travelling abroad, renders a country a debtor, while it is a creditor for the expenditure of foreigners within its territory, that is, of course, so far as the parties in question derive their power of expenditure from their native country.

Such are the principal elements which go to determine the balance of indebtedness. It is possible that some minor cases may be found which are not included in the foregoing analysis; and most writers on the subject have contented themselves with a less minute division of the several items. It is, however, essential to direct attention to the cardinal fact of the equation of indebtedness, which is the condition to be satisfied in all continuous solvent trade. The equivalence of

[1] See Giffen, *Essays in Finance* (2nd Series), pp. 171-189, and *Statistical Journal*, vol. lxii. pp. 9-12. Bankers' commissions in a commercial centre like London would be very similar.

imports and exports may or may not exist; but there is no advantage or disadvantage in an excess of either of these amounts. A country may, for a considerable period, have an excess of exports over imports, and be prosperous, or the reverse.[1] And the same is the case with imports; but a country which has a balance of indebtedness against it will have to alter some of the items of the account, or clear away the balance by a number of bankruptcies. The establishment of the equation of indebtedness is for every country what Cairnes declared it to be for the United States—"simply the condition of her remaining a solvent nation."[2] It follows that this principle may be safely used for the purpose of deducing conclusions with regard to trade movements. As, in general, the imports and exports are the most easily altered items of the account, a readjustment in the amount of indebtedness will take effect through them, and an unfavourable balance will be discharged by a reduction of imports, an increase of exports, or a combination of both processes.

The examination of the complicated relations of

[1] Examples in point are: the position of the United Kingdom with its great excess of imports; that of the United States, where the exports as a rule exceed the imports; and the permanent excess of exports in the case of India. A common fallacy is to regard the relation of imports to exports as being connected with the particular commercial policy pursued. Usually, the plea is that protection is necessary in order to stop excessive imports, but sometimes, as in the case of Ireland, it is alleged that Free Trade is bad because the exports are greater than the imports. See on this latter form of the fallacy Cairnes, *Leading Principles* (1st ed.), p. 500, and on the whole question of the relation between imports and exports, Giffen, *Essays in Finance* (2nd Series), pp. 132-239; also his paper on "The Excess of Imports," *Statistical Journal*, vol. lxii. pp. 1-69.

[2] *Leading Principles*, p. 445.

international trade enables us to make a needed modification in the theory of our subject. In the preceding chapter we had apparently established that the equation of international demand could, if broken, be restored only by an alteration of prices produced by the passage of money, or by a change in the ratio of the currencies in the countries in question. We are now in a position to understand that a foreign loan may maintain the equation of indebtedness, and may obviate the inconvenience of a sudden change in prices, which may not, on the whole, and taking a long period into account, be needed. This function of securities is most useful, since it gives stability to prices which would otherwise fluctuate unduly, and further relieves countries from what might be the cause of much inconvenience and loss, viz. the sudden drain of a large amount of money-material. It is with respect to nations possessing a fully-developed credit-economy that the service is most important.[1] The matter may be put in a somewhat different way by saying that a country at times can create an immaterial export by means of its securities, which export it has to meet at a future date by sending out an actual export of equal value—interest, of course, being paid in the meantime. The practical applications of the doctrine concerning the equation of indebtedness will be best handled in connection with the protectionist controversy; but the foregoing general statement is an essential preliminary to any treatment of the foreign exchanges, to which branch we shall next proceed.

[1] The expedient is, of course, only a temporary one, but it is nevertheless important to note its existence. Compare the criticism of Lorini, *La Moneta*, p. 324.

CHAPTER V

THE FOREIGN EXCHANGES[1]

IT is now requisite to look more closely at the actual form of international trade. We have hitherto considered the forces operating on the terms of exchange, either on the supposition of barter, or after the introduction of money. The next step will be to see in what mode the indebtedness created through the several elements described in the preceding chapter is discharged. In practice we find that debts are reduced to the form of bills—"foreign Bills of Exchange," to use the full title—and we can thus derive some knowledge from examining the working of these bills. In order to give definiteness to our ideas, let us take an assumed case. X, a merchant, in one country, A, has sent goods to a certain amount to Y, a merchant in another country, B; W, a merchant residing in B, has sent goods of equal value to Z, who lives in A. How will the liabilities thus created be discharged? There are several alternative courses. X and W may

[1] Viscount Goschen's *Theory of the Foreign Exchanges* is an old standard work on the subject, but Mr. Clare's *Money Market Primer*, and his *A B C of the Foreign Exchanges*, give much fuller details and supply modern examples of exchange operations. Pierson, *Political Economy*, vol. i. pp. 516-567 (Eng. trans.), is serviceable, as supplying fresh examples from the foreigner's point of view.

fetch back the value of their goods in money, or they may exchange them for an equivalent amount of commodities, which will be brought back and sold by them; and such is really the primitive system of trading. If the obligations were formed in the countries of the creditors, Y and Z would have to transmit an equal value to X and W; and when money is developed, it is almost certain that this value will have to be sent in that form, since it is the only legal tender. By either of the methods just mentioned there would be in general two streams of money passing between A and B in opposite directions. Another way of discharging the obligation is, however, available. Let us suppose that X draws an order desiring Y to pay the debt that he owes to X, to the bearer of the order, and that he sells it to his countryman Z, who discharges his debt to W by sending him the order, and finally that W presents it to Y, and obtains the amount. By this simple arrangement the expense of a double transmission of money-material is avoided, and two transactions are closed by the use of a single Bill of Exchange, as X's order is called. Y's debt is then said to be drawn for, and Z's to be remitted for.[1]

The several individuals in the supposed instance may be regarded as types of so many classes; and the relations between X and Z in A, and Y and W in B, will be carried out by means of an intermediate class of dealers who make the foreign exchanges their special

[1] "Mr. Seyd's estimate is, that one-third of our exports are drawn for, and two-thirds remitted for." Palgrave, *Notes on Banking*, p. 43. According to Mr. Clare the proportion drawn for is much smaller. He suggests 10 per cent as the probable amount, and accounts for its smallness by reference to the position of London as a monetary centre, and the consequent convenience of drawing bills on it.

business. The exporter of commodities will part with his bill to one of those dealers, who will, in turn, sell it to a debtor for the purpose of being transmitted in discharge of a debt to a foreign country, where it will probably pass into the hands of another exchange-broker for collection. But whatever be the actual course adopted in particular cases, the general result is the creation of a new commodity, which is bought and sold on terms, settled in accordance with the conditions of supply and demand.

In the case just stated the debts due on each side were equal. What Y owed to X was exactly balanced by Z's debt to W, and, therefore, the exchanges were equal—a fact which is expressed in technical language by saying that they are at *par*. When this is the case, it is plain that the question of indebtedness is realised, since bills are not merely the result of exports and imports, but of all forms of debt. Another consequence must be noted. There is no need of the passage of money to meet a balance, and we may, therefore, conclude that a state of equilibrium is attained when the exchanges are at *par*. As yet only the main and primary factor in exchange relations—that is to say, indebtedness—has been mentioned. There are several complicating circumstances which tend to obscure the ultimate force at work. It is hard to arrest the phenomena which are in continuous motion for the purpose of analysis. The bills, which are hourly being drawn, are for varying periods of time, and are drawn by and on persons of very varied degrees of credit, and, as a necessary consequence, show these influences in their market price. Again, almost every nation has its peculiar currency system, and, therefore, there is

the necessity of measuring the value of a bill expressed in one system by the terms of another. From this side we get another and more concrete definition of par of exchange; it is attained when the money of one country is equal in value to an amount of the money of another country containing the same quantity of money-material. The difference of currencies, though it is perplexing, and renders all calculations more troublesome, yet does not create the system of the foreign exchanges, which results from the primary fact of indebtedness, combined with the cost of transmitting money from one place to another. In general, too, the fact of different legal jurisdictions, or *fora*, is a juridical ground for treating bills as "foreign"; but it is not a necessary condition. Owing, then, to the various complicating circumstances, the exchanges are in constant movement; but they move within definite limits, which may be concisely indicated. If at any particular time the equation of indebtedness is not established, it follows that the claims of one country —say A—on the other—say B—are greater than those of B upon A; therefore the supply of bills in A will be greater than the demand for them, and, in order to induce a sale, they will fall below their nominal value. The converse will be found to take place in B; there the demand for bills will exceed the supply, and their value will rise above the amount which they represent. The exchanges will be below par in A, and above par in B. There are, however, limits to the rise in the value of bills in B, and their fall in A; nor, if we keep the elementary facts steadily in view, is there much difficulty in seeing what they are. Why does a merchant in A sell his bill at a

lower value than its nominal amount? Plainly because actual money is worth more than the amount to be obtained by the bill, which will have to be sent to B to be cashed, and the proceeds of which will have to be carried back to A at expense and risk. Therefore, the cost of bringing back bullion would be the limit to the fall in value of bills in A. In like manner, bills in B will not go beyond the cost of transmitting bullion from that country, since a debtor there, instead of buying a bill, would, were it cheaper, remit the amount of his debt in bullion. It may, therefore, be concluded that the limit to exchange fluctuations, in either direction, is fixed by the cost of the passage of specie—a statement which may also be put as follows: —The upper limit of exchange operations is *par*, plus the cost of transmitting specie; the lower limit *par*, minus the cost of transmitting specie; so that twice the cost of sending specie is the whole space within which fluctuations ordinarily take place. Each of the limits is known in technical language as a specie-point; and thus we may say, that the specie-points are the limits to exchange fluctuations, while the position of equilibrium is *par*. Within these limits, however, the movements are incessant, and are affected by all the conditions already mentioned. In the illustrative case given above, the balance of indebtedness was in favour of A, and against B; therefore, to restore equilibrium, the passage of some bullion would, in general, be needed; but exchange operations will reduce the amount to a minimum, and in this way save expense. Since the bullion has to pass from B to A, the exchanges are said to be favourable to A, and unfavourable to B—terms which have descended

from the time of the mercantile doctrine, when the influx of money was always regarded as beneficial, and its outflow as injurious. The theory on which this idea was based is universally admitted to be erroneous; but Viscount Goschen has pointed out that in certain states of the money-market the efflux of bullion is detrimental, and that from the monetary point of view there may be some justification for the use of the terms.[1]

To enable a more vivid conception of the actual course of exchange operations to be formed, it will be well to take a couple of selected instances from the present time, and first will naturally come the exchange between London and Paris. In this case both countries have in practice the same standard metal—gold; and since one pound sterling contains the same amount of pure gold as 25 francs and $22\frac{1}{2}$ centimes, the par of exchange is said to be $25{\cdot}22\frac{1}{2}$. The cost of sending £1 between London and Paris is about one-eighth of a franc, or $12\frac{1}{2}$ centimes; consequently, the specie-points may be taken as 25·10 (*i.e.* $25{\cdot}22\frac{1}{2} - {\cdot}12\frac{1}{2}$) and 25·35 (*i.e.* $25{\cdot}22\frac{1}{2} + {\cdot}12\frac{1}{2}$). When the rate for short bills is near 25·10, a movement of bullion will take place from London to Paris, in order to obtain the profit which may be expected; and the opposite will occur when 25·35 is approached. Within these comparatively narrow limits, the exchange will be constantly moving in accordance with the variations of supply and demand. The exchange between London and New York will, in like manner, illustrate the elementary facts of the exchanges. Here the par of exchange is $4{\cdot}86\frac{2}{3}$, since the gold in one English pound is equal to that in $\$4{\cdot}86\frac{2}{3}$; the cost of

[1] *Theory of the Foreign Exchanges*, p. 86.

transmission of the pound sterling would be about $3\frac{1}{4}$ cents; from which we can infer that the specie- (or shipping-) points are 4·83 and 4·90 approximately.

It should be remarked that these conditions in strictness apply only to what are called "short" bills, that is, bills which are due, or almost due; in the case of long bills—those which have some time to run before becoming due—the disturbing influences of rate of interest and state of credit have to be considered, and will cause wider fluctuations. It is possible to state similar pars and specie-points in the case of any two commercial centres; but for the purpose of illustrating the abstract principles, it will be unnecessary to add further instances.[1]

Though, in general, the value of bills can only vary within the narrow limits set by the specie-points, there are some curious cases on record where these bounds have been passed, and where much larger rates of discount and higher premiums have been obtained. These exceptions to the general principle themselves admit of classification. The cases in which the exchanges may fall below specie-point are two, and may be stated as follows:—(1) Where a stringent money-market is coexistent with a favourable exchange. For, suppose two nations, A and B, in the former of which there is great monetary pressure, and from which there has been a large excess of exports over imports, or, at all events, a favourable balance of debts; it follows that the supply of bills in A will exceed the demand for them—a circumstance which would in ordinary times bring the exchanges to the lower specie-point, but not further. Now, however, the influence of the stringent

[1] For fuller details see Clare's *ABC of the Foreign Exchanges.*

money-market comes in. Dealers are unwilling to invest their money in bills which cannot be cashed for some time, and therefore the demand for them is reduced; moreover, the holders of bills are anxious to obtain money, which is the only form of legal tender, and is therefore peculiarly needed at times of pressure; and thus the discount on bills goes below its normal limit—a phenomenon which is accompanied by a high rate of interest, and a general fall in the prices of commodities and securities.

A striking instance of the operation of these conditions is presented by the American Exchanges in 1860-61. The United States had exported largely to England, and at the same time, owing to the probability of the outbreak of civil war, had reduced their imports, the consequence being a balance in their favour. The political conditions had produced a desire for money on the part of dealers, who were willing to sell their bills at a sacrifice, rather than wait for their maturing and encashment in England, and the return of the proceeds in specie. Both conditions were essential for the production of the unusual fall. Without the state of apprehension, it would not have gone beyond specie-point; without the favourable balance, the buyers would have been as numerous as the sellers, or, to speak more accurately, the demand for bills would have sufficed to carry off the supply.

(2) In another instance a similar depression of the exchanges is possible. In a new country, especially one which produces the precious metals, there may be some difficulty in obtaining coined money, and there may be, for a short period, an excess of importations, and yet the bills in that country on others may fall

below the specie-point, though in the normal state they ought to command a premium (*infra*, p. 95). The explanation is to be found in the scarcity of coin, which is the medium needed for the purpose of closing transactions. A usually concurrent fact is the depreciation in the value of bullion. The position of the Australian Exchanges in 1852-53 is a case in point. The demand of the miners for all the ruder kinds of goods had stimulated importation, but the natural effect of this force was more than counteracted by the want of metallic money, therefore bills fell not only below their par value, but even far below specie-point. To any one looking at the mere facts of the exchanges, it would appear that gold would move towards Australia —and indeed in one form it did. It was imperatively necessary to import coined gold, though at the same time much larger quantities of bullion were exported. The establishment of branch mints at Melbourne and Sydney removed this anomalous state, and effectually prevented its reappearing at any future time.[1]

In contrast to the instances which we have just examined, other cases may be found in which the exchanges rise above the specie-point. Though they are reducible to one general head, it is easier to treat them as consisting of two distinct classes:—(1) Where a sudden demand for gold for exportation occurs, or is expected to occur, in a country with an inconvertible paper-currency which is not depreciated. The price of foreign bills may, under these circumstances, go far above specie-point, since they give the power of obtaining legal tender abroad, and thus obviate the

[1] Tooke-Newmarch, *History of Prices*, vol. vi. p. 682. For a somewhat similar case, in the exchange with China in 1856, see *ibid.* p. 685.

need of gold, which has become—owing to the probability of its being demanded for exportation—a highly-valued commodity. The sudden rise in the exchanges in 1815, mentioned by Mill,[1] is a good illustration of this set of cases. (2) The position of inconvertible paper-currencies, which have been depreciated from excessive issue, or from discredit, is closely akin to the first and more limited case. Here the exchanges may pass, not only beyond specie-point, but even many hundred per cent beyond it. The easiest way of conceiving the operation of a depreciated currency is to regard it as a new commodity, whose value in specie has to be estimated in order to find the true exchange; or, to use the well-established terms, the exchange, measured in depreciated paper, is the nominal, that estimated in terms of bullion, the real exchange; and, therefore, the fluctuations of the nominal exchange have to be eliminated in order to interpret the movements of the real exchange. The best indication of the amount of depreciation is to be found in the price of bullion, which has become a commodity, and the limit to the rise in price of bills, measured in depreciated paper, is set by the premium on bullion. The purchaser has to consider whether it is cheaper to buy a bill or to buy bullion, and thus the prices of both these articles are connected. The movements of the exchanges may be further retarded by legal restrictions on dealings in bullion; but such measures, though harassing, and likely to cause some additional expense, are, in general, evaded. When a country having an inconvertible paper-currency has exhausted its stock of bullion, the commodity best suited for export will take

[1] *Principles*, iii. 20, § 3, note.

the place of the former, but, of course, will be less easily used for the purpose, since all other commodities are more or less destitute of the qualities which have made gold and silver, but more especially the former, the money-material *par excellence*. The difficulty in selecting an actual instance of this class of cases arises not from their scarcity, but from their abundance. The course of the American Exchanges between 1862 and 1878 is a leading and well-known example which may be specially mentioned. At one time the premium on gold reached 285; but bullion always commanded a premium of greater or less amount.[1] A still later example, and one still in existence, is that of the exchange with Buenos Ayres. Owing to the depreciation of the Argentine currency the rate of exchange is high and uncertain.

Similar principles apply to the exchanges between gold-using and silver-using countries. As Viscount Goschen has shown,[2] the price of silver in the former, or of gold in the latter, will have to be taken into account; and it is by the price of that metal which is merely a commodity that the limit of fluctuation is determined. As we have seen already (pp. 59, 60) this element is prominent in the case of Anglo-Indian trade, and it is highly desirable to see that the fluctuations of the Eastern exchanges are explicable on the same general grounds as those of countries with depreciated paper issues.

The general principles of the exchanges have now, it may be hoped, been sufficiently stated, and also the

[1] See A. S. Bolles, *Financial History of the United States* (1861-1885), p. 301, note.

[2] *Foreign Exchanges*, pp. 76-81. Cp. Clare, *A B C of the Foreign Exchanges*, pp. 139-142.

limits within which they move, as well as the various exceptional cases where, in consequence of a change in the normal conditions, the variations become wider, or, at least, may do so. To complete the examination of this subject, it is requisite to see the working of the various influencing forces within the usual limits. "The fluctuations which actually take place in the foreign exchanges," says Viscount Goschen,[1] "are at once the necessary result and the certain index of the inequalities which exist in the indebtedness of different countries—inequalities either in the amount of their liabilities, or in the time within which payment must be made, or in the relation of the currency of one country to that of another." Taking the different circumstances thus clearly stated in their due order, we find that the comparative amount of indebtedness is the primary cause of exchange variations. If A owes more to B than B owes to it, the exchanges will, other things being equal, be favourable to the latter and unfavourable to the former. In dealing with all concrete instances, this fact must never be lost sight of. For a complete interpretation, the other elements of the problem have also to be included. Time operates in two ways—1st, by rendering the rate of interest in both countries an important element in determining the price of bills—the rate in the country where bills are drawn, "since it renders the seller more eager and the purchaser more reluctant";[2] the rate in the country on which bills are drawn, since the bills are purchased to discharge debts in, or to procure gold from that country, and, in either case, the rate of interest there will affect their value; and 2nd, by

[1] *Theory of Foreign Exchanges*, pp. 4, 5. [2] Goschen, p. 53.

making the state of credit a more prominent condition, as there is a greater amount of risk in the case of a three-months' bill than in that of one "at sight." The time within which the liabilities on each side have to be discharged is, therefore, a necessary element in the determination of the exchanges. The currency of the countries is, too, a factor in the settlement of the terms, and, in the case of inconvertible paper circulation, the most potent one. In general, where the monetary system in both countries is sound and well established, there is no fluctuation produced by it, though the effect of the other disturbing forces is expressed in terms of currency; so that, at first sight, the whole problem of the exchanges seems to be merely the comparison of the moneys of different countries.

The doctrine of the exchanges includes some account of what have been called its "correctives." The term implies a state of things which needs correction, and, therefore, may be placed along with the expressions "favourable" and "unfavourable," as being due to the "balance of trade" doctrines of the seventeenth and eighteenth centuries. Using the word as merely descriptive of an actual process, we may say that the modes of correcting the exchanges are: 1st, increased exportations; 2nd, diminished importations; 3rd, reform of currency, if it be depreciated; 4th, an elevation in the rate of interest. The operation of the two first-mentioned methods is obvious, as they alter the balance of indebtedness, and thus correct an unfavourable exchange in the most direct way. Currency reform, when needed, raises the credit of the whole country, so as to improve its trade position. The last-mentioned method is the course usually pursued in England. The

raising of the rate of discount has been now for many years the recognised way of checking a drain of gold. Its operation should, therefore, be carefully noted. It produces the desired effect, first, by making it more profitable to invest money in the country thus acting; the higher the rate of interest, the less will be gained by sending long bills for the purpose of getting them discounted, there will thus be an inducement to let them await maturity; then the price of securities tends to fall as interest rises, and securities in the supposed country become a specially valuable investment. Secondly, trade in general is checked by the higher rates, and prices of commodities are lowered—a change which acts directly on the amount of imports and exports, lowering the former and increasing the latter; and thus, in fine, the raising of the rate of interest increases ordinary exports, and makes securities and bills more likely to be used as immaterial exports. Experience amply confirms the conclusion derived from abstract reasoning. To take a good instance, the drain of gold to the United States in 1861 was checked by the elevation of the English rate to 8 per cent.[1] To avoid misapprehension, it should be said that there is nothing artificial in the operation of this agency. The Bank of England, as a large holder of loanable capital, raises its rate of discount in order to keep its reserve unreduced. Other holders of capital follow this example, and thus a general elevation of interest for short loans takes place—a change which is favoured by the position of trade; for otherwise the Bank of England's movement would not be followed by the other holders of capital, who would undersell

[1] See Laveleye, *Le Marché Monétaire*, pp. 179, 180.

it in the terms of loans, and draw away its customers.[1] This course, therefore, is suggested, and even necessitated, by the dictates of self-interest, and its operation has been most advantageous in preventing undue fluctuations in the exchanges and heavy drains of gold.

Apart, however, from all conscious correctives of the course of exchange, there is, in the conditions of the phenomena themselves, a force which tends to preserve equilibrium, and which has been briefly formulated in the proposition that "the exchanges have a tendency to return to *par*." In proof of this statement, let us, as so often before, take two nations, A and B, the former of which has a favourable balance as against the latter, and, as a necessary corollary, the latter of which has an unfavourable balance; then bills in A on B will be at a discount, and bills in B on A will be at a premium, since in A the supply would exceed the demand, while in B the demand would exceed the supply, that is, assuming the price to be at *par* in each case. Should, however, this state be due to any transitory cause, it is likely to be corrected without the passage of bullion, since the discount on bills in A will reduce the profit of exporters, who will lose by the low price of their bills, and may find it expedient to curtail their transactions. At the same time, exporters in B will gain the premium on their bills, in addition to their ordinary profit, and may thus be led to increase the amount of exports. This force acts on both sides of the balance, and is, in almost all cases, operative to some extent. It can, however, only affect slight fluctuations, as the heavier balances would, in all likelihood, need a readjustment of prices, for which

[1] Cp. p. 64, note.

the actual passage of bullion is essential; and further, the extent to which the influence of the gain just described is effective, neutralises that gain, since, if the exchange is corrected by it, the gain itself disappears.

In practice, exchange operations are not confined to dealings between two countries. There is a close connection between all the great commercial centres, which prevents an extreme deviation in the terms of any particular exchange. One form of this connection is so important that it may best be taken to illustrate the general fact. In three trading countries, A, B, and C, A may have an excess of exports—omitting, for simplicity, the other forms of debt—to B; B, in like manner, may have an excess of exports to C, who, in turn, may have an excess of exports to A. Here A can discharge its debt to C by means of the surplus bills on B which it possesses, and B can make a like use of its surplus of bills on C; so that the transactions may possibly be all discharged without the use of bullion. The case just described is known as "triangular trade." The most familiar instance is the trade of (*a*) India and China, (*b*) the United States, and (*c*) England, which exactly illustrates our supposed case of A, B, and C. Eastern countries have an excess of exports to the United States, and they again have a surplus of exports to England, the latter paying her debts to America by her exports to the East; or, to speak more accurately, America pays her debts to the East by bills drawn on London. In general, a debt due anywhere will be paid by bills drawn on another place, if a profit can be made by so doing; and in foreign bill dealings, the influence of self-interest is probably stronger and keener than in

any other form of economic activity. The technical term for the method of thus clearing bills is "arbitration of exchange"—a process which is abundantly illustrated in the technical treatises on the subject.[1]

More important than the complicated rules for working the exchanges, is the general principle that a nation's position is not determined by its trade with any one other nation, but by the sum of its relations with other countries. The establishment of the equation of indebtedness is the ultimate condition—a result which may, on its exchange side, be stated as follows: —The stable position—assuming money to be constant in quantity and indestructible—is that in which the real exchanges are at *par*, or, allowing for the actual mode in which money is supplied, a slightly favourable exchange for a non-gold-producing country, and an unfavourable exchange for those countries which produce and export the precious metals. To give an actual instance, the exchange with Melbourne is generally favourable to England. Bills in Melbourne on England are usually at a premium (£102), which is equivalent to saying that the cost of sending *specie* from Melbourne to London is about 2 per cent. Though exchange operations, in general, are connected, so that wide deviations are checked, yet it is quite possible for a country to have a permanently favourable exchange with some nations, and an unfavourable one with others. Such a state of things indicates that the country in question

[1] The details of exchange operations are given in Seyd's *Bullion and Foreign Exchanges*, and Tate's *Cambist* (23rd ed.). The many changes in currency systems during the last twenty-five years have much reduced the value of the former work. Mr. Clare's already-mentioned work, *The A B C of the Foreign Exchanges*, is now by far the best book for the economic student.

is an intermediary in distributing bullion from the mines to the various other countries of the world.[1]

Looking back on the theory of international exchange, we see that, no matter in what way it is contemplated, a condition of equilibrium is the state towards which it tends. In Chapter II., under a system of pure barter, we found that the equation of reciprocal demand was the normal condition, brought about through the action of human desires on each side. By introducing the additional element of money (Chapter III.), we saw that the distribution of the precious metals was always approximating to that position which would make the trade similar to one of barter—a result accomplished by the difficulty of moving bullion and the consequences of its transmission. Though we had to further amend our views by the recognition of other relations than those arising from imports and exports, we have yet established in the present chapter that the equation of indebtedness is the position towards which international trade tends, when worked as it actually is, by credit instruments. We may, then, conclude that the exposition of the theory is well founded, since, from such different points of view, it gives precisely similar results, and we can feel the greater confidence in rejecting any doctrines which are inconsistent with it, as well as in advocating any practical measures which are its logical outcome.

[1] "Spain, for example, who is the great importer of bullion from America, can never have an unfavourable exchange with her colonies; and, as she must distribute the bullion she receives amongst the different nations of the world, she can seldom have a favourable exchange with the countries with whom she trades."—Ricardo, *Reply to Bosanquet* (*Works*, p. 313).

CHAPTER VI

THE INFLUENCE OF FOREIGN TRADE ON THE INTERNAL DISTRIBUTION OF WEALTH

THE effect of the opening of foreign trade on the economic condition of a country requires a closer examination than it has yet received. The general result has been already stated, so far as production is concerned. The widening of the circle of exchanges allows a greater amount of utility to be obtained by a given effort, and, as the utility in question is purchased, it is equivalent to an increase of wealth. The aggregate production of a community is extended, and thus the aim of economic effort is obtained in a better manner than it would be without the new influence of international trade. It is possible, however, that objections may be raised to regarding this result as the only one for consideration. Allowing that production has been augmented, the effect on distribution, and the changes which foreign trade will introduce in that side of economic life, remain to be estimated.

To discuss this question properly, it is essential to indicate briefly the ordinary theory of distribution as stated by Ricardo and his successors. Its main outlines are as follows:—All wealth is distributed amongst the owners of the three productive agents

—Land, Labour, and Capital—and the conditions governing the division of the produce are, under a system of free competition, definite and similar to natural laws. The owners of land obtain an amount determined by the position of the "margin of cultivation," *i.e.* by the return in produce to the marginal or least productive unit of labour and capital; the cultivators of the more productive units being compelled, through competition, to give up their extra gain in the form of rent to the owners. The comparative unproductiveness of any unit of labour and capital may be the consequence of (*a*) inferior fertility, (*b*) worse situation, or (*c*) application in unfavourable circumstances, owing to the higher returns having been obtained by previous units similarly employed. The margin of cultivation is determined by the demand for agricultural products—mainly food—and thus depends on the amount of population. The rate of wages is fixed by the amount necessary for the labourer's subsistence; and the rate of profit—the remaining portion of the produce—can be computed from the rate of wages, combined with the return to a unit employed at the margin; or, more simply, by ascertaining the mass of profit, which is simply the remainder after wages and rent are deducted, and then, from the amount of capital, computing the percentage of gain.

Into the various difficulties raised by this theory, when thus stated in abstract form, it is not necessary to enter. But it cannot be denied that, as a first approximation towards a scientific account of the partition of wealth, and as clearing the mind preparatory to further inquiry into the facts of distribution, its value has been great. In any modern

society the result of social growth has been to establish a set of complicated relations which do not conform to the simplicity of the Ricardian analysis. Instead of a single and uniform rate of wages, measured by the labourer's necessary requirements, we have various social groups, most of them paid at a much higher rate than any minimum of subsistence, no matter how liberally interpreted. The uniform rate of profit is replaced by widely divergent gains, obtained in thousands of varying industries, whose conditions are most imperfectly known. The amount of rent is affected by the operation of various disturbing forces, and is, in many cases, mixed up with profit. Above all, there are large classes of the community who are in the receipt of fixed incomes derived from different sources, and whose position has to be carefully considered before attempting to estimate at least the proximate influence of changes in the conditions of production, and their effect on distribution.

The result of foreign trade may, however, be treated in a more general way than would be allowable, were our object to develop a theory of distribution which would adequately explain the actual facts to be found in modern societies.[1] First, it is evident that imported commodities are obtained at a cheaper rate by means of foreign trade—*i.e.* if by cheaper be simply meant

[1] See Leroy-Beaulieu, *Essai sur la Répartition des Richesses*, for an interesting treatment of this more general problem. The general theory of distribution has been very fully discussed in the standard treatises of Professors Marshall and Nicholson, but unfortunately the former writer has not as yet reached the subject of international trade; and Professor Nicholson's treatment, while largely in accordance with that in the text, is affected by his use of *prices* throughout. See Appendix C.

at less sacrifice—and thus the consumers of such commodities are benefited. To give a more definite result, we have to take into account the nature of the commodities imported, and the persons who consume them. If costly luxuries, they become accessible to a wider class, or leave a margin to the former consumers for further outlay; if articles of general consumption, the benefit is diffused among the society, and affects all classes. The importation of food has specially important effects. Assuming for a moment the older doctrine of wages as being naturally at the minimum, it would raise the rate of profit, and thus help to increase the accumulation of capital, while it would be quite consistent with Ricardo's express statement to believe that it would temporarily, and even perhaps permanently, improve the condition of the labourers.[1]

The modern developments of the economic theory of distribution enable us to attribute a still more advantageous result to foreign trade. The readjustments of industry, which are its most likely consequence, permit of greater efficiency in production, and therefore under a state of freedom will assign to the labourer a greater amount of real wages, whatever be his comparative gains when measured against those of other classes. Another consequence, which necessarily follows from the importation of food and other products of extractive industry, should be particularly noticed. The gloomy view of the future

[1] "It is not to be understood that the natural price of labour, estimated even in food and necessaries, is absolutely fixed and constant. It varies at different times in the same country, and very materially differs in different countries. It essentially depends on the habits and customs of the people."—Ricardo, *Works*, p. 52.

of society, which is so strongly suggested by Ricardo's speculations, arises in the main from the certainty of the augmentation of "unearned wealth" in the shape of rent, which is there set forth; and though Mill and Cairnes hoped to modify this tendency by the action of society, and by the prudence of individuals, it is clear that they held similar views. The latter went even further, and declared that the tendency had actually been effectual. "The large addition to the wealth of the country," he tells us, writing in 1873, "has gone neither to profits nor to wages, nor yet to the public at large, but to swell a fund ever growing, even while its proprietors sleep—the rent-roll of the owners of the soil."[1] The importation of raw materials—using that term in its proper sense—tends to alter this state. Increased food-supplies keep the margin of cultivation higher than it would otherwise be. The cheapening of other products of extractive industry reduces the gains of the owners of mines and forests, so that the general tendency of foreign trade in such articles is to lower rent—at the same time increasing the sum of utility—and thus to improve the distribution as well as the production of wealth.[2]

[1] *Leading Principles*, p. 333. Cp. J. S. Mill: "The economical progress of a society constituted of landlords, capitalists, and labourers, tends to the progressive enrichment of the landlord class; while the cost of the labourers' subsistence tends, on the whole, to increase, and profits to fall."—*Principles*, iv. 3, § 5.

[2] It is therefore by a true instinct that the owners of land in all old and long-settled countries have been advocates of protection. The removal of restrictions tends to lower the amount, or at all events the relative share, of unearned wealth, and may stop its being an unearned "increment." In new countries, where the conditions are different, landowners are generally inclined towards freedom of exchange.

A very effective illustration of this operation of foreign trade is supplied by the readjustments in distribution that have been the outcome of modern improvements in transport. During the last twenty-five years, rent in old countries has been falling, and at the same time the price of food has been reduced. Money wages have hardly altered, and thus the labourers have gained, in part at least, at the expense of the landlords. England under its free trade *régime* shows the change most distinctly, but continental countries, though their protectionist policy helps to disguise it, are affected in the same way.

The case of manufactured products is somewhat different; the needs which they supply are not on the whole so pressing; and therefore it might seem as if a reduction in their value was not so urgently to be desired. Still, outlay on the products of elaborative industries forms a large part of expenditure, and a reduction in their cost leaves room for greater outlay on food, if more of it be needed, or for the supply of other wants hitherto unsatisfied. If we bear in mind the proven connection between imports and exports, it is not difficult to see that any alterations and reductions in particular industries are necessarily accompanied by development and extension of others, which, from the very conditions of the case, are more efficient producers of wealth. The possible evils inflicted by foreign trade on special groups of workers are strictly analogous to the effects of industrial improvement in general, and must be so classed for the purpose of scientific discussion. And as there can be no hesitation in pronouncing a favourable judgment, in spite of all drawbacks, in the case of the latter, a

like result may be claimed for the former. There are, however, some special cases which will repay examination, since they throw light on the application of economic principles to the interpretation of concrete instances.

In considering the theory of international values, we found that in general the effect of foreign trade was to alter the distribution of productive power among the various national industries, and thus to allow of a larger amount of production being carried on; but we also recognised the exceptional case, where domestic trade itself consisted in the dealings of non-competing groups, whose exchanges, owing to the absence of free competition, were regulated by reciprocal demand; and here we saw that it was possible that no readjustment of industry would take place, that there would therefore be no increased wealth to divide, and consequently that the gains of one group would be balanced by the losses of another (pp. 32, 33). Such would be a likely result in a community where industrial castes were fully organised; and here it is plain that prices might simply be lowered in the case of imported articles to the loss of their producers, and for the benefit of their consumers. In treating of the theory of value, we were further led to conclude that there was a real gain to the whole body of non-competing groups comprised in the nation—a gain, that is, not in production, but in distribution, since the undue charges of the producers of articles capable of importation have been reduced, and a better distribution of wealth to that extent, at least, obtained; and, therefore, in this case, too, the advantage of foreign trade exists; though the members of the groups who

previously were enabled to earn a monopoly reward will not readily accept the doctrine. For the purpose of theory, this case has been put in its strongest form; yet, for practical application, it is important to remember that so rigid a division of industrial groups will almost certainly be accompanied by the phenomenon of customary prices, and that foreign trade will affect the nation by causing the export of those articles whose price allows of it, while the ordinary agent for restoring equilibrium—the elevation of prices—is wholly or partially absent. The loss to a nation so organised is evident; but it consists rather in the low terms obtained for its exports than in any "inundation" of foreign goods, or break-up of some of its industrial groups. The existence of highly specialised castes in a society formed on the competitive type is hardly to be looked for; and, if it were, would indicate a state of social relations which would require each group to have the right of supplying its wants on the cheapest terms, instead of being compelled to pay what would be in essence a tribute to a body with which it had nothing in common except residence in the same territory.

The law of diminishing return has been justly regarded by English economists[1] as a proposition of weighty import, and with good reason, since, were this law non-existent, the main features of the theory of

[1] And, indeed, by all sound reasoners. Cp.—"The law of population, therefore, combined with the law of the diminishing return, constitutes the great underlying condition of society. . . . Let him, therefore, who desires to study social phenomena, first learn the transcendent importance for the whole social organisation, industrial, political, and civil, of the ratio of population of land."—W. G. Sumner, *Essays*, pp. 83, 84.

distribution would be quite different from what they are. It is therefore to be expected that the extent to which it operates will require investigation in treating of foreign trade. It has been already noticed (pp. 30, 31) that the law of diminishing return tends to restrict the sphere of international trade. What has now to be considered is the reaction of foreign trade on an industry subject to that law. The effect of increased demand will naturally be to lower the margin of cultivation, to increase the cost of production, and to permit of the obtaining a larger amount of rent on the proceeds of the particular industry: in fact, the results are precisely the reverse of those to be expected where a country imports raw materials (p. 101). The most important instance of this kind will be found in the case of a food-exporting country. The effect of foreign trade is to bring worse soils into cultivation, and to raise the value of food, thus permitting of an increase in the amount of agricultural rent. In this instance, the labourers, and possibly the capitalists, may suffer while the landlords gain.[1]

In practice, however, the effect on the margin of cultivation will be modified by the fact that the imports will be obtained, in general, at a cheaper rate

[1] The results stated in this and the succeeding paragraph have been independently reached by Professor Loria (*Statistical Journal*, vol. L. pp. 408-420). In a developed and exaggerated form they are the basis of the ingenious argument for protection contained in Professor Patten's *Economic Basis of Protection*, chap. v. According to him, "The policy of free trade has the same effect on a new, progressive nation, like America, that would result from a large increase of its own population. . . . There will result a lower margin of cultivation and higher rents" (*Economic Basis*, pp. 47, 48). See also Rabbeno, *Protezionismo Americano*, p. 503, and the discussion of Sidgwick's and Professor Edgeworth's views in Appendix C.

—imports which, being manufactured products (since the country whose case we are considering is an agricultural one), will be subject to the law of increasing return, and thus be steadily falling in value. The gain from this source, even to those producers whose industry is employed on less productive soil, will afford some recompense for their loss through the enhanced cost of food. If rent be supposed to be distributed somewhat evenly among the population, the advantages will be still more evident, since, in addition to the cheapness of imports, the gain by increased rent will partially balance the rise in the value of food, and on the whole account there will be a gain. In the theory of the subject it is necessary to recognise the possible injury which may be inflicted on the labourers of a community—an evil in some degree resembling that resulting from a rapid increase of population; and where a sharp line of demarcation has been established between the rent-receiving and rent-paying classes, it is possible that the conflict of interest will become very severe. Thus Irish labourers might be injured by a large demand for food from England, even though, to some extent, the cheapness of imported goods would counteract the effect of dear food. A similar result, it should be added, is not to be expected in the United States or in the English Colonies, since there property in land is widely distributed, and circulates freely among the different classes of society.[1]

[1] Mr. Devas regards the statement in the text as "a plea that avails just as much for agricultural protection as for free trade. . . . This would have been a defence for the English Corn Laws had England, like France, been a country of small proprietors" (*Political Economy*,

On the whole, the result of the preceding paragraphs can be concisely expressed by saying, that there is always a gain by the opening of international exchange, though it may sometimes only consist in the abolition of a monopoly; that this gain, when it causes an increase of total utility, may either accrue to the community at large, or be appropriated in part by the owners of natural agents; and finally, that, in a soundly-organised community, it is almost certain that, though the ordinary action of purchase and inheritance, the increased amount of rent will be divided among a large part of the population, and therefore that even on the side of distribution there will be no ultimate loss to any section of the nation.

Throughout the present chapter, the gains or the conceivable cases of loss which might arise have always been measured in terms of wealth, or rather of utility, and no reference has been made to prices. We have seen, however, that in all probability the scale of prices, under a system of international trade, will be different from that which would exist were trade merely domestic. It is therefore possible that in a given country, wages, profits, and rents, measured in money, may be all lower or higher than they would be without any foreign trade—a circumstance which

p. 308). He, however, overlooks an important difference between the two cases. Under free trade there is a gain by the importation of manufactures on cheaper terms, which is absent when protection intensifies the condition of diminishing returns. The amount returned in higher rent is only a part of the total extra cost. Thus the plea is not a "defence," but rather an extenuation or mitigation of the offence. But it is better not to offend at all. For this effect of the Corn Laws cp. *infra*, pp. 136-137, and for a careful study of their influence on agriculture see H. Levy, *Die Not des englischen Landwirts*.

has led to much confusion as to the real forces and conditions governing international exchange. For the purpose of an abstract theory of distribution, it may not be necessary to regard closely the transitory conditions of a period of change; but in seeking to estimate the effect of changes, when first introduced, we cannot ignore the fact, that in every civilised society there are to be found large classes whose incomes are fixed, and will remain so for a considerable time, as also large numbers of debtors whose obligations are defined in money. The changes in price rendered necessary by the new conditions of foreign trade will therefore affect them just as would any other change in the value of money, so that the results already established for that general case may be applied here.[1] These, in their broadest form, are as follows:—The industrial classes, on the whole, gain by increased prices, since they are rather debtors than creditors. Employers gain, at first, more than labourers, since prices rise more speedily than wages. Persons receiving customary remuneration suffer at first; but they often succeed in changing the customary rate of pay. Mortgagees, annuitants, and fund-holders suffer without any corresponding advantage; and, in general, the less industrial any social group is, the more likely it is to be injured by increased prices. A fall in prices has directly opposite effects, which need not be further detailed. The fact of a rise or fall of prices, due to foreign trade, is not, however, easily ascertained, and, moreover, the changes in real, as distinguished

[1] See Jevons, *A Serious Fall in the Value of Gold*, chap. iv. (reprinted in his *Investigations*, pp. 77-92); Cairnes, *Essays*, pp. 146-158; J. S. Nicholson, *Money*, pp. 233-238, 250-255, 263-265.

from money, value, are so interwoven with it, that it is quite beyond the power of abstract reasoning to give anything but the most general results. It is certain that high money returns to industry are due to two sets of conditions:—(1) Those determining industrial efficiency; and (2) those regulating the cost of money: the latter have been already stated (pp. 69, 70); the former are to be found in every economic text-book.[1]

Finally, the influence of international trade on the industrial system of a country may be noticed. Here we find that it tends uniformly to break down customary conditions, and to encourage the extension of competition. We have abundant evidence of this in the course of economic history. Whatever other effects may be attributed to international exchange, it cannot be doubted that it weakens the restraints of status, and leads men to adopt in their dealings the more developed, and therefore, in a scientific point of view, higher system of competition.

[1] See, *e.g.*, J. S. Mill, *Principles*, book i. chaps. vii. and viii.

CHAPTER VII

TAXATION FOR REVENUE IN ITS EFFECTS ON FOREIGN TRADE

WHEN treating of the various conditions affecting international values, we found it necessary to consider the results which followed from impediments to exchange, without making any distinction as to their origin; and such a method of procedure was evidently legitimate, since the effect on value was produced by the mere existence of the impediment, not at all by its special features. There is, however, one kind of hindrance which, on account of its practical importance, needs a separate investigation, viz. that caused by duties levied on imports and exports. For the present we will only inquire into the operation of revenue duties as distinguished from those which seek to "protect" native industry. The aim of the persons imposing the former is—or ought to be—to obtain a maximum return, and therefore the greater, *cæteris paribus*, the amount of goods passed from country to country, the greater will be their satisfaction. "Protective" duties, on the other hand, are only completely successful when all foreign goods are excluded, and therefore attain their end most effectually when they bring in no revenue whatsoever. We are, however, here dealing

with facts, not with desires or intentions, and consequently, when a duty, ostensibly levied for protection, does bring in some return, we shall regard it as being, to that extent, a revenue duty. There is, of course, no protection where an equivalent tax is imposed on the home product, even though no revenue is obtained on the importation of the article; since it is certain that the removal of the tax would not cause any change, as the native producers would retain the same relative advantage. The reason for a special treatment of the particular class of impediments under consideration lies in the fact that, while all other hindrances require efforts to overcome them, and are thus a dead loss, taxes may increase the State's revenue, and help it to meet the expenses incurred in the discharge of its functions. Still they are a deduction from the gain of exchange, and their influence and true effects can only be known by regarding them from that point of view.

Taxes may be levied either on exports or on imports,[1] and it will be found most convenient to commence by examining the operation of the former class of imposts. Suppose, then, that—all other things remaining the same—a country imposes an export duty on one of its staple products, the natural result will be a rise of price, owing to the enhance-

[1] Transit duties are probably earlier than either import or export duties, but they have now little importance. They no doubt may bring in revenue to the State at the expense of foreigners, but they tend to reduce and divert traffic, and accordingly lower the gains of transport agencies in the country employing them. The duty levied on opium passing from the native states to China through British India is the best known example of such a charge. Cp. *Wealth of Nations*, p. 379.

ment of its expenses of production for foreign markets; the foreign demand for the commodity in question will in all probability be reduced, and the change in demand will almost necessarily entail an alteration in the conditions affecting the equation of indebtedness, but in what direction it is beyond the power of abstract reasoning to point out without more precise facts to work on. Two conditions of particular weight in determining the final results are—(1) the position of the exporting country as a producer; and (2) the nature of the demand for the commodity in the importing countries. Should the exporting nation possess a monopoly of the production of the taxed article, it is evidently possible that the tax may at least partially fall on foreigners; but if other countries produce the commodity, it is almost certain that exportation will cease, and that a loss will be inflicted on native producers, while no revenue will be obtained. It is, therefore, only in instances where a virtual monopoly exists that export duties have ever been even suggested. The extent and the intensity of the foreign demand will also affect the productiveness of the tax, as well as its incidence. Where an increase of price largely reduces the quantity sought for, it is possible that the amount exported may be less in value than before the imposition of the duty, and thus the equation of indebtedness may be altered to the disadvantage of the exporting nation. These facts lead directly to the proposition usually adopted by writers who have entered on this topic, viz. that an export duty is only expedient, on economic grounds, where the country imposing it has a monopoly of the article taxed, for which article, moreover, the foreign

demand is intense.[1] It is supposed that in such a case the duty would fall on the foreign countries which consume the taxed commodity. The export duty on opium in India, and also that levied on wool in mediæval England, have been regarded as illustrating this proposition, and for similar reasons an export duty on cotton has been advocated in the United States. The *data* set forth above do not warrant the conclusion so confidently drawn, since they will be found on investigation to be incomplete. It is not the demand for any single commodity which determines the equation of demand—omitting, for simplicity, the still more involved relations arising from the forms of indebtedness in general—but the comparative demand for all the exports and for all the imports (pp. 37, 40); from which it follows that even if the demand for the taxed commodity be undiminished, yet that for other exports of the taxing country may be reduced; and, since the purchasing power of the importing countries will necessarily be lessened by the increased expenditure on the taxed article, such a consequence is very likely. As all international trade is connected through the operation of the foreign exchanges, the loss to the taxing country may perhaps be experienced in its trade with countries which do not import the taxed commodity, but whose relations with it are affected by the alterations in the general terms of exchange produced through the operation of the duty. For the purpose of illustration, we may take the possible effects of the export duty on Indian opium. Even granting

[1] See Thorold Rogers, *Six Centuries of Work and Wages*, p. 79. The four conditions there specified are all included under the two mentioned in the text.

that the Chinese demand for that drug remains unaffected by the tax, it yet may happen that the demand of China for English manufactures will be reduced thereby, and that in turn the terms on which India receives silver from England will be altered. The consequence of this change might indeed be such as to favour India, and thus present an additional inducement for the imposition of the duty; but it would be impossible to decide which would be the final result.

Some further considerations bearing on this very difficult subject should not be overlooked in any attempt to estimate the influence of export duties. One of these is the operation of the law of diminishing return. Where that law governs production, an export duty will, to some extent, fall on rent, since if it slightly reduces the amount exported, the production of the most costly portion will be abandoned, the price, apart from the tax, will fall, and to that extent the owners of the more productive agents still employed in turning out the taxed commodity will suffer. As demand is frequently fluctuating, and the raw material in nearly all industries is more or less subject to the law whose effect we are considering, it is impossible to show that this result is not always to be found in the case of export duties.

Again, taxes on exports may be defended as, under certain conditions, being equivalent to a national association to raise their price. Thus, reverting to our Indian example, it might be argued that under free competition the price of opium would be fixed by cost of production at the lowest profitable amount,[1] but that the duty will raise the price, and thus have

[1] For this doctrine, cp. Sidgwick, *Principles*, p. 183.

the same effect as a combination of dealers or a trade union in the market for commodities or for labour. We have already (p. 29) recognised the existence of this possible case; but to estimate its probability, the whole state of international indebtedness has to be examined, and especially the conditions of reciprocal demand as regards other commodities.

It should be remarked that export duties on exhaustible articles which are aids to production—as in the cases of English coal and Peruvian guano—have to be mainly judged on non-economic grounds; but the reasons which justify such measures will prescribe duties on home consumption as well.[1] From the financial point of view, all duties on exports which are not highly productive are objectionable, since they fail in the first object of taxation. Export duties have not in general been popular, as they conflicted with the views of the mercantile theorists, who aimed at increasing exports, and who consequently preferred to give premiums on exportation, instead of loading it with duties. It was only in the case of raw materials that such taxes were tolerated, and then only with the object of preserving them for the use of the native manufacturers of finished products.[2]

Import duties next claim our attention. They, too, are impediments to trade, and, in general, tend to reduce its advantage. Like export duties, they operate on the terms of exchange, through the necessary readjustment in the equation of reciprocal demand.

[1] See Jevons, *Coal Question*, pp. 354-364. For the export duty on English coal, imposed in 1901, see *Economic Journal*, vol. xi. p. 225.

[2] See *Wealth of Nations*, book iv. chap. viii.; cp. Bastable, *Public Finance*, p. 513.

As when dealing with taxes on exports, let us suppose that—no other change taking place—a country imposes a duty on a particular commodity which is imported, and which, to simplify the inquiry, we will assume is not produced in the taxing country. The price will at first be raised by the amount of the duty, and probably the demand will be diminished. This diminution will lead to a further alteration, since, the demand being reduced, the importing country will have a balance in its favour which will have to be liquidated by a flow of bullion towards it; and the terms of exchange will be altered to suit the new state of things; but, as with export duties, the actual result cannot be predicted. Here, again, there are conditions of primary importance for forming a correct judgment on the probabilities of the case—(1) If the demand of the taxing country for the commodity be weak, it is possible that the alteration may be to its advantage; and (2) if there be no other country which requires the taxed product, it is evident that its position is made still stronger; for the weakness of demand will lower the value of the imported article, and the absence of any other market will render it advantageous for the producers to sell at any terms above those set by the limits of comparative cost. In truth, these conditions are analogous to those which we met when dealing with export duties.[1]

[1] This resemblance has been elsewhere described by saying "that there is a kind of symmetry in the action of both classes, so that import duties are really export ones reversed." Professor Edgeworth, in his examination of international value from the mathematical economist's standpoint, denied the existence of this symmetry, and declared that "the want of symmetry between the effects of . . . taxes on exports and imports is the conclusion which can be most peculiarly and exclusively attributed to the mathematical method"

There the most favourable instance for the duty was monopoly of production, combined with intensity of demand. Here it consists in weakness of demand, with monopoly of consumption, if the phrase be permitted.[1] Instances of this latter kind are, however, of rare occurrence; there are very few articles which are only used in one country, and the demand for which at the same time falls rapidly on a slight elevation of price. It would, therefore, appear that it is extremely difficult to tax foreigners by the instrumentality of duties on imports.[2] It, however, not infrequently happens that some particular class of producers may find their best market in a particular country. An import tax imposed by that country on their product, if it seriously reduces demand, may fall on them. Possible instances are supplied by the alleged effect of the duties under the U.S. tariff of 1890 on the prices of tin-plates, Sumatran tobacco, and Canadian farm produce. An import duty in England on Irish cattle would, it is likely, fall in part on Irish producers. It must be added that it is very difficult to discover the real operation of such taxes. Price movements are due to many different causes, which are not easily disentangled, and the precise weight to be assigned to each is hardly ever capable of determination.[3] Import duties have, how-

(*Economic Journal*, vol. iv. p. 435). Further consideration, however, led him to the conclusion "that the symmetry predicated" above "does in general exist."

[1] "Buyers' monopoly" is Sidgwick's phrase, *Principles*, p. 340.

[2] The different conclusion arrived at by Mill, *Principles*, v. 4, § 6, may be explained by his confining his attention to the case of two countries, by which course the element of monopoly, both in supply and demand, is implicitly introduced.

[3] The controversies as to the real effect of the M'Kinley tariff

ever, been generally preferred to taxes on exports; but their aim has been either to afford "protection" to native producers, or the more reasonable and legitimate one of obtaining revenue from the consumers of the imported articles.

Though it is not easy to discover a case in which import duties, imposed by one country only, would fall on the foreign countries that export the taxed commodity, yet a modified form, which closely resembles it, is far from being uncommon. Suppose that a number of countries all impose similar duties on articles which are the staple products of certain other nations: here the taxing countries may constitute the principal market for the product; their demand may be reduced by the tax, and, if so, some, and even perhaps most, of the loss from the impeded exchange would be borne by the producing countries. Thus, let us assume that all the various nations of Europe were to levy the same amount of import duty on tea, which is the product of a different group of nations—economically speaking—viz. China, India, Japan, Ceylon, and Java: there is nothing absurd or unreasonable in supposing that a reduction in the quantity demanded would, at first, be the result; leading to an offer of all Eastern products on more advantageous terms. In this particular case the conditions would favour such a change, since an elevation in price of an article not absolutely necessary, but still generally

illustrate the statement in the text. See Edgeworth, *Economic Journal*, vol. iv. pp. 45, 46, and Mr. Shearman's criticism, *ibid.* vol. iv. pp. 524-527. Cp. Professor Nicholson's remark (*Scottish Geographical Magazine*, Sept. 1891), "The incidence of import and export duties, especially when the direct effects are considered, is the most complicated and difficult problem in economics."

consumed, quickly reduces the demand. A similar extension of the propositions relating to export duties is also justified. A tax on the export of wine in all wine-producing countries might fall, for the most part, on the countries which imported it; but here the condition of intensity of demand would probably be absent, and, if so, the rent of vineyards would have to bear an indefinite amount of the duty. In general it must be said that, as the conditions of supply and demand, in domestic trade, can be affected by skilled combinations, so the same forces in foreign trade can be made to yield like results by the use of analogous means. Export duties are, as we have said, similar in effect to combinations of producers, as import duties to those of consumers. Nor does the resemblance cease here. The two sets of influences are alike in their weakness as in their strength. The outside dealer who does not join in the combination is yet able to profit by its results; and, in like manner, the producing nation which does not impose export duties gets the advantage of the increased demand which is directed towards its part of the produce. Thus, suppose that France, Spain, Italy, and Germany imposed an export duty on wine, but that Portugal did not, then manifestly the latter country would profit by the duty, while getting also the advantage of increased demand. So likewise if, while all other European nations levied duties on imported tea, England admitted it free of tax, she would profit by the reduction of demand, and thus get her own supply at a cheaper rate than if there were no duty—in fact, she would gain the same advantage as the taxing countries by the operation of the duty, while her inhabitants would not suffer from the incon-

venience of restricting their demand, which would be the consequence of the higher price in the other countries. The above conclusion is, of course, drawn without prejudice to cases in which the tax may be the best mode of raising revenue from the native consumers. It only applies when the duty is not imposed on purely fiscal grounds, but rather as a mode of manipulating the equation of reciprocal demand.

The considerations just adduced appear to have an important bearing on a question which has been much discussed of late years, viz. the effect of foreign tariffs on British trade. The advocates of high tariffs in the United States and other countries have contended that the duties imposed on imports from England have been paid by the English producers, and have not raised prices. A similar idea is, to some extent, to be found prevailing in England. In seeking to deal with this matter, we must first lay aside the case of protective duties, which have been reserved for further examination, and confine our attention to duties which bring in revenue. The existence of high duties in most foreign countries may, it is clear, reduce the demand for English products, and thus affect the terms of exchange to that country's disadvantage. The loss, however, would fall on the nation as a whole, not on the special class of producers for export, unless they possessed a monopoly, when the duty would, indeed, be a deduction from the monopolists' gains, which can hardly be regarded as those of producers proper. That such has been the actual result is not established by anything like the amount of evidence required. The fact (if fact it be) that the difference in price between English and American iron is not as great as the

amount of the import duty does not prove it, since, if it were generally true, no iron would be imported, and the duty would not be one of revenue. The occasional import of iron at a low price is equally unsatisfactory, since there is no way of judging of the special circumstances—as, *e.g.*, bankruptcy of a particular firm—which may have made such a step desirable. Nor is it necessary to prove a difference in price between English and American iron (the duty excluded); for, if the iron industry be carried on under normal conditions, it is not possible that English producers will sell their product cheaper in foreign countries than at home, as, by lowering the price of the home product slightly, the demand would be so increased as to carry off the stock now sent abroad, and the action of competition would almost necessarily have this effect, since, were it otherwise, iron must be above its cost value in England, or below it in America; but in the former case a monopoly value would exist; in the latter, English exporters would be trading at a loss. It follows, therefore, that, regarding the trade as a continuous one, the prices of imported iron in America must exceed those in England by an amount equal to the sum of the impediments to transfer, *i.e.* cost of carriage and duty. The real adjustment of the incidence of revenue duties will be through the scale of prices prevailing in the countries concerned; and it is quite possible that the heavy taxes on English manufactures, especially in the colonies, where they operate chiefly as revenue duties, may have some such effect; but nothing beyond this admission is warranted by evidence, nor is it easy to see in what way the actual existence of such a condition of things could be established or refuted.

The foregoing remarks suggest another aspect of the question of tariffs—What is the position of a single country without such duties when trading with a number of countries, all of which have them in full force against the productions of all other nations? We have seen (p. 119) that a country without duties may gain the advantages of the export or import duties imposed by other countries, and at the same time be free from their disadvantages. The nation of our supposition is in a somewhat similar situation. Her trade is, indeed, affected by the duties of other countries; but, then, so also is the trade of each of those countries, while she has an advantage when competing with any of the duty-levying nations for the consumption of the products of a third country. The terms of exchange are altered by the operation of the duties, and, in addition to this advantage, she gets the commodities she needs by as much less as the amount of the duty in other nations. In the export trade she has the benefit of her cheaper imports, so far as they are auxiliary to production, which, in a highly-developed system of industry, must be generally an important factor; and she further possesses the advantage given by the influence of freights (pp. 46, 47), by reason of which, other things being equal, her exports will be preferred to those of the countries which levy high duties. When the advantages and disadvantages of such a position are compared, it is highly probable that the former will be found to exceed the latter; but, for a more precise determination, the size and number of the various taxing countries should be taken into account; for the smaller the number of taxing nations, the less opportunity there

will be for obtaining the advantages just pointed out. The conclusions thus arrived at, by deduction from the elementary conditions governing international values, are, in some degree, verified by the position of England as regards her foreign trade, more especially in respect to competition with other countries in neutral markets. It should, however, be carefully noted that all such statements must be taken subject to the qualifications necessarily involved. They are drawn from the examination of a few leading features of foreign trade applied under conditions which have been much simplified, and are thus far removed from reality—a characteristic which makes them quite unfit for that sweeping application to practice which has been the greatest weakness of the older English economic school. But, this caution notwithstanding, these more refined considerations present a double advantage, for (1) they indicate the proper direction of statistical inquiry, and thus enable those conversant with the facts of trade to supply the suitable clothing which will render them, when corrected, capable of interpreting the phenomena of international exchange;[1] and (2) they discharge a useful negative function in refuting the doctrines of so-called practical men, which are in reality made up of unsound deductions from defective premises. The most thorough investigation of the

[1] The studies of Sir R. Giffen (*Reports on Foreign Trade*) and Professor Flux ("The Commercial Supremacy of Great Britain," in *Economic Journal*, vol. iv. pp. 457 *sq.* 595 *sq.*; vol. ix. pp. 173 *sq.*, and "British Trade and German Competition," *Economic Journal*, vol. vii. pp. 34 *sq.*) may be referred to as admirable examples of statistical method. On the other hand, Mr. Williams's *Made in Germany* may be noticed as affording a warning of the dangers that beset the incautious.

general forces which are at work in determining the course of foreign trade, shows the great complexity of the phenomena to be dealt with, as well as the improbability of any conscious intervention being likely to alter the course of exchange in the interests of a particular country.

Bounties, either on exportation or importation, are, from the scientific point of view, "negative taxes"—to use Cournot's phrase.[1] They artificially reduce the value of the commodities to which they are applied, just as ordinary duties raise it; and, therefore, they tend to increase the amount of foreign trade, and so far produce a gain which will be divided among the trading countries, according to the conditions of demand existing at the time: but in addition they involve an outlay on the part of the nation which pays them greater than the gain obtained, since the necessity of the bounty proves that the industry supported by it is less profitable than that to which, without interference, the productive power of the country would have been directed. It is probable that most of the advantage will go to the nations which import the subsidised product; and it is certain that the expense of the bounty will fall wholly on the country bestowing it. If the commodity be subject to the law of diminishing return, the lowering of the margin of production may raise the cost of the most expensive part, when the bounty will partly go towards rent, and partly be lost in the extra cost of production. The well-known instances of the bounties on beet-root sugar illustrate instructively the operation of both these cases, since the raw material is subject to the

[1] *Théorie des Richesses*, p. 374.

law governing all extractive industry, while the manufactured product conforms to the ordinary rule. It is possible that in an industry where the amount of produce rapidly increases with concentration and application of labour and capital on a large scale, the gain thus obtained would equal, or perhaps exceed, the loss incurred by the artificial re-distribution of production; but even here the loss to the State's revenue would not be compensated, and there is little chance of the development, under a bounty system, being superior to that which would result from complete freedom. From the scientific point of view, it is, however, right to indicate the possibility of such a case, though its realisation is hardly within the region of practice.

One particular class of taxes presents such peculiarities that it is best treated apart, viz. that of charges levied on the money-material. What, *e.g.*, would be the effect of an export duty on Australian gold? In this case the law of demand is perfectly regular, and the raising of the value of bullion ought apparently to be met by a reduction in the quantity needed for exportation. As, however, there are other gold-producing countries, and as gold does not apparently change in price, the result would be that the tax would fall on the producers, and therefore, if the industry were regularly organised, necessarily on the owners of the mines. Assuming effective competition, it follows that the production of gold would be diminished, and its value would rise, thus benefiting all gold-producing countries, and in some degree the whole world, since the gold employed as money is, of course, a dead loss, *i.e.* so far as its functions could be

discharged by a smaller amount. What holds true of export duties partly applies to taxes on the importation of the precious metals, which, in general, take the form of seigniorage. So far as internal trade is concerned, they enable the country to manage with a smaller stock of bullion, while they allow of its preserving the due scale of prices; but they hinder the working of foreign trade, and check the speedy adjustment of the exchanges. Should all countries establish a similar amount of seigniorage on their coins, it seems clear that it would in reality be a tax on the production of the precious metals, that is, so far as their production is carried on in the ordinary way, otherwise it would be equivalent to a general rise of nominal prices. It, perhaps, ought to be added that the absence of all mint charges is in fact a bounty on the importation of bullion, as Dudley North clearly saw.[1]

Before quitting the subject of taxes for revenue, which are calculated to affect the course of foreign trade, it may be advisable to look at such duties, taken as a whole. Thus regarded, they appear as a deduction from the gains by international exchange, against which their yield in revenue to the States imposing them should be set off; but in this calculation of advantages and disadvantages, all the elements involved must be considered. Every duty on the transfer of commodities is more or less a "privative" tax. It hinders some persons purchasing the article, and diminishes their enjoyment, without any corresponding advantage to the revenue. All import and export duties—the case of taxes on money excepted—have

[1] *Discourses on Trade* (1691).

this effect. They therefore cause greater loss than gain; as each duty, in some degree, reduces the field of exchange, and the resulting utility. That such is the outcome of these taxes, in their extreme form, Mill fully recognised; for even when suggesting retaliatory import duties, he adds: "Only it" (the nation imposing them) "must take care that these duties be not so high as to exceed all that remains of the advantage of the trade, and put an end to importation altogether."[1] It is one of the many strange things in his economic writings, that he should suppose that the movement from complete freedom to total cessation of exchange took place *per saltum*. It is evident that each addition to the duties on either side would remove some of the advantage of exchange, and that every reduction would somewhat increase it. Duties on commodities may be necessary to the financier; but his object should be—entirely disregarding the fiscal policy of other nations—to obtain the maximum of revenue. A purely revenue duty aiming at "retaliation"—if such be not even a contradiction in terms—is manifestly uneconomical, and thus offends against the fourth of Adam Smith's famous maxims, all of which should be substantially obeyed in a sound financial system.

[1] *Essays on some Unsettled Questions*, p. 29.

CHAPTER VIII

THE RATIONALE OF FREE-TRADE

THE theory of international exchange, as developed in the preceding chapters, shows with sufficient clearness the nature—and the advantages which are the reason for the continuance—of such exchanges. All impediments to transfer, since they limit the possibilities of gain, are inexpedient, or at least there is a strong presumption against them. Popular opinion, unfortunately, takes a very different view of the results in question; and it seems to be one of the best-accredited articles of the vulgar belief that foreign trade requires to be carefully watched, in order to prevent the injuries which it is likely to inflict on the national industry and commerce. Even among those who call themselves "free-traders," there are many who advance propositions quite inconsistent with the elementary principles of economics respecting foreign trade. Under such circumstances, it is not necessary to apologise for adding another to the many controversial discussions of the matter, the more especially as some notice of it is requisite in a complete examination of the problems of International Exchange. The practical rule of "free-trade," [1] — that is, the

[1] The term "free-trade" has been used in very different senses. Thus in the seventeenth century it meant "freedom to export

removal of all artificial restrictions on, or encouragements to, any particular industry; the levying of duties for the purpose of obtaining revenue, and from no other motive; the levying of equivalent excise duties where customs duties are requisite; in short, the abandonment of the efforts, once universal, to divert industry into some channel into which the action of the normal economic forces would not have directed it,—is a deduction from the theory of foreign trade as it has been here expounded; and any arguments which ignore the theoretic bases that have been developed, may be passed by as being outside the field of reasonable discussion, or if mentioned, will only be noticed as illustrations of the effect of erroneous doctrines when applied to practice.[1]

bullion," or, again, "the right to trade without being the member of a privileged company." In the eighteenth century it meant "freedom of export." This was the sense in which it was employed in Ireland. As the editor of the last edition of Hutchinson's *Commercial Restraints* remarks with unconscious irony: "'Free-trade for Ireland' in 1779 meant something quite distinct from the political economy free-trade of the present day. . . . The Irish Free-trade Parliament was Protectionist" (*Commercial Restraints of Ireland*, ed. 1888, by W. G. Carroll, p. lxxii. note 1). "Free-trade" has also been used to denote a system under which no duties whatever are levied on imports and exports; but the weight of economic authority is in favour of the use given in the text. See the articles on "Free Trade" (*Early History*), by Professor Hewins, and (*Theory*) by the present writer in Mr. Palgrave's *Dictionary of Political Economy*.

[1] Mr. E. Williams—*The Case for Protection*—is offended at this mode of treatment, which he regards as "meagre" and "cavalier"; but he has failed to recognise that the discussion in the text rests on the theory developed in preceding chapters, which he has passed over under the erroneous belief that it is algebraic. (Is all general reasoning "algebra" to Mr. Williams?)

It may further be remarked that Mr. Williams has carefully avoided any notice of the examination of protectionist arguments in the present writer's *Commerce of Nations* though an express

The particular basis of free-trade here set forth has found distinguished expositors in Ricardo, J. S. Mill, Cairnes, and Cherbuliez; the contributions of the two last-named being peculiarly forcible and well-reasoned.[1] Yet it would be unjust to a large number of able economists not to say that a similar conclusion has been worked out on other grounds, some of them perhaps more easily recognised by persons unversed in social and economic theories.

Among these various schools we may here notice: Firstly, The believers in "natural rights," who object to State-interference with any exchange, on the ground that man has a natural right to exchange his products —a right which is violated by all protective tariffs. Bastiat is, perhaps, the most conspicuous advocate of this position; in his eyes the French custom-house official, who levies a tax on the importation of Belgian iron, does not differ from the robber who seizes on a portion of the iron in transit, since each equally violates the right of the owner. Protection, in all its forms, is thus only a new kind of theft.[2] It cannot be denied that such a mode of arguing has often produced an effect where the more refined considerations which result from economic theory would be quite unavailing. In many cases, too, it brings into

reference was given to it (*infra*, p. 151 n.) Such a notice would have been inconvenient; its omission, however, supplies a test of the "candour" of which Mr. Williams boasts.

[1] See Ricardo, *Works*, pp. 407, 408; J. S. Mill, *Principles*, v. 10, §1; Cairnes, *Leading Principles*, pt. iii. chap. iv.; Cherbuliez, *Précis*, vol. ii. pp. 53-108.

[2] See specially, "Spoliation et Loi," *Œuvres*, vol. v. pp. 1-14, where the resemblance between protective duties and robbery is most fully developed.

light the selfishness and trade-interests which have established protection, and thus is legitimate as a means of attack. It errs, however, in taking too negative a view of the functions of the State; and, to some extent, it suggests what is not only illegal, but immoral. Were Bastiat right, it would follow that the smuggler, so far from being an offender, would be really the assertor of the rights of man against the oppression of the State—a result which, if extended to all departments of administration, would bring us close to anarchy. The enlightened American citizen may deplore the fiscal policy of the United States, but that need not hinder him from aiding in the repression of offences even against those fiscal laws to which he is so strongly opposed. The support of law as law, entirely apart from the merits of the particular enactment, is a feature of every well-organised community; and it is only when the pressure of bad laws has become unbearable that the time for resistance has come.

Secondly.—The school which reinforces the argument from abstract right by considerations of utility, is well represented by Adam Smith. He opposes restrictions on trade as being "violations of natural liberty, and therefore unjust; they are, too, as impolitic as they are unjust."[1] And all through his treatise the same combination is to be found. It should, however, be said that it is on the element of expediency that most stress is laid; when the two factors are opposed, it is natural liberty that has to give way.[2] The whole system of the *Wealth of Nations* is, as

[1] *Wealth of Nations* (ed. Nicholson), p. 217*a*.
[2] *Ibid.* p. 133*a*.

Leslie has shown,[1] based on a combination of *a priori* speculation with historical inquiry, to which general proposition the case of free-trade is no exception.

Thirdly.—A large number of practical men seek to justify their support of freedom of exchange by appeals to specific experience. The orators of the anti-Corn Law League most frequently took up this position: the speeches of Villiers and Cobden were not made up of long chains of deductive reasoning; they, for the most part, dwelt on the actual distress of the English people, and particularly on the miserable condition of the agricultural labourers. They contended that the removal of restrictions would relieve the sufferings of the population, and therefore that free-trade was desirable. There is little that is valuable for economic theory in the speeches and writings of the leaders of the League. Nor could anything of the kind be reasonably expected of them. Similar in character is the evidence submitted to the Committee of 1840 on import duties. The specific evils arising from high protective tariffs are simply pointed out by the witnesses, though, of course, some of them were well acquainted with economic science. The valuable contributions of D. A. Wells show a like disposition among American free-traders;[2] and there can be little doubt that the exposure of all the injuries inflicted on industry by restriction is an aid in weakening the sentiments which favour protection. Still the inherent defects of this line of argument should be remembered. It is impossible to apply the experimental method in

[1] "The Political Economy of Adam Smith," *Essays*, pp. 21-40.

[2] See his *Practical Economics*, pp. 21-33, and 64-151; but in other writings he has argued for free-trade on the ground of natural right.

its strict form to social phenomena, inasmuch as the requisite separation of the different agencies cannot be accomplished. When, therefore, the free-trader seeks to attribute certain losses to the influence of protection, his opponent may reply that they are due to some other cause; and so long as the controversy is confined to the discussion of unanalysed experiences, neither party can establish its case with my confidence.

Fourthly.—Another line has of recent years been taken by some free-traders: they hold that freedom of exchange is the outcome of social development. The mercantile system was, they admit, of great service in its day. Protection may be necessary as a temporary assistance, but for an advanced system of industry free exchange is beneficial, and should be the ultimate object to be attained.[1] With the historical school we must agree in the idea that freedom of trade is the result of industrial and social progress; but we can also add, that the supposed advantages of protection, at an early stage of growth, are not so manifest as writers of that school seem to believe. Since most German economists incline towards this view, it is well to notice it in its relation to the other grounds on which free-trade has been urged; but its practical value is of the slightest.

The general line of reasoning on which the expediency of free-trade is best supported may be easily obtained from the theoretical discussions and analyses which have previously occupied our attention. In every particular exchange there is necessarily a gain to each party concerned; but the sum-total of exchanges

[1] See Laveleye, *Le Socialisme Contemporain* (1st ed.), pp. 39, 40. Roscher, *System*, vol. iii. §§ 138-141.

is composed of the several particular exchanges which have been made; and as each of the latter implies a gain, the immediate result must be beneficial. As the aim of protective duties, on the other hand, is to hinder exchanges, they are necessarily injurious. This brief statement contains the main point of the free-trade argument; but it may be further developed. We saw (Chapter II.) that impediments to transfer reduced the gain from exchange; but as duties for the purpose of protection are avowedly impediments, they must have this effect. For the purpose of clearer examination, we divided duties (Chapter VII.) into two classes—the former, which aimed at getting revenue, might, under certain conditions, be made to fall on foreign countries, and might possibly be advisable; but this peculiar application was so limited that we were led to recognise the expediency of using them with the single aim of getting a maximum return; and when that object was realised, the gain to the revenue might counterbalance the loss to the exchangers. In the second class of duties, those which were used for "protection," this element of gain was absent. The loss which results from the hindrance exactly resembles that inflicted by difficulty of transport, and thus brings back no compensating advantage. It is here that the weakness of modern protectionism is most apparent; strenuous efforts are made to remove natural obstacles to exchange, and then, strange to relate, many persons seek to establish artificial ones to "protect" national industry. Thus we are told that "after the St. Gothard tunnel was opened the people of Southern Germany petitioned the Government to lay higher taxes on Italian products, to offset

the cheapness which the tunnel had produced." [1] And this is but one of many similar instances. Indeed, it is evident that the rapid expansion of new modes of transport in recent years has had a potent influence in producing the protectionist tendencies of the day.

The system of protective duties is not sufficiently treated by merely pointing out its evil results in general. It is also necessary to show more fully the nature and extent of the losses incurred by such a policy. They may be outlined as follows: —The wealth of each of the communities hindered from trading is reduced; the division of the loss cannot be ascertained by general reasoning; but that each will to some extent lose is almost certain, the only exception being in the case previously discussed (p. 28), where one nation might obtain all the gain by exchange, and therefore, as the other nation gained nothing by foreign trade, it would lose nothing by its cessation. Dismissing this abnormal instance as being, under the actual complications of trade, impossible, let us see in what the loss consists. It is to be found in the enhanced cost of the articles which, under free-trade policy, could be imported. It is plain that increase of cost is the object of the duties in question, since otherwise there is no reason for their existence. The contention of American protectionists, that prices are not raised by protection, may be disposed of by considering: 1st, that it is incorrect in fact, as every price list shows; and 2nd, that, if true, it would only prove that protection is not needed.[2] In

[1] Sumner, *Protectionism*, p. 75.

[2] Some protectionists seem to argue that undue fluctuations of

addition to the increase in the cost of imports, the less economic distribution of the productive forces of the nation leads to a reduction in the amount of wealth. International exchange is, as previously pointed out (p. 20), a form of division of labour, which is a main condition in the increase of inventions, and industrial skill. Impediments on transfer, then, hinder the development of division of labour, and, so far as they are effective, destroy its benefits.

The consequences of protection are in some respects different, according as it is applied to commodities, extra quantities of which are produced at increased or diminished cost. In respect to the latter class, it tends to remove the advantage which is obtained by production on a large scale, and thus is injurious to all parties concerned. The efforts to encourage the development of native manufactures in many countries at the present time afford a good example of the operation of this part of the protectionist scheme. It is beyond question, that a great saving of productive power would accrue to the world at large by the concentration of manufacturing industries at those places which are favoured by technical and economic conditions—a saving which would be shared by all the nations of the world, and not be confined to the manufacturing countries.

When the protected industry is subject to the law of diminishing return, the influence of protection is

price are obviated by their system; but the history of prices in England under the Corn Laws, and for the last thirty-five years in the United States, conclusively shows that quite an opposite effect is produced.

somewhat different. It raises the cost of the product, and either reduces the demand for it, or lowers the margin of production, with the result, that part of the increased value is returned in the form of rent, the remainder being absorbed in the production of the more costly portions of the article. The English Corn Laws precisely illustrate this case. The value of corn was raised, and, at the same time, the demand for it was reduced. Part of the increased value was lost in the cultivation of inferior soil;[1] the remainder went in higher rent; but, owing partly to the check on the increase of population arising from the dearness of food, and partly to the heavy expense of pauperism, the landlords did not, on the whole, gain. With regard to the countries exporting the article on which a protective duty is imposed, it is plain that the cost of their product may be lessened, since the margin of production will not be fixed at so low a point; but the amount of rent will be reduced, and the possible gain by the exchange for other articles will be lost. Thus —to illustrate our reasoning—it is probable that the cost of corn in Ireland in the early part of this century would have been reduced by a protective duty imposed by England on Irish wheat; that the consumers of corn would gain, and the owners of land lose, but the hindrance to the exportation of corn would also hinder the importation of English products, and Ireland would, therefore, lose the advantage of getting her manufactured goods at a cheaper rate,

[1] Evidence taken by the Agricultural Committee of 1821 showed that while the best land yielded forty bushels of wheat, some land in cultivation gave but eight bushels. See Ricardo, *Works*, p. 459; and for the inferior quality of some of the land put under wheat, see Cobbett, *Rural Rides*, vol. i. pp. 225, 244.

and, in addition, the development of industrial power through the extension of inventions would be retarded.[1]

When the industry of a nation is not entirely based on competition, the effect of a protective duty may be to give undue advantage to some classes of producers, and thereby necessarily to injure others. In this case, as we have already seen (pp. 32, 33), the benefit derived from foreign trade is not increased production, but fairer distribution of wealth.

The examination of the general course of foreign trade, and its various possible modifications, leads us to the doctrine that all attempts to hinder it by means of protective duties are injurious to the nation which adopts such a course, as well as to the countries with which, under freedom, it would trade; and the reasons for such a conclusion seem so clear and simple, that it is difficult to understand why they have not been universally adopted. We find, however, that protectionism is, outside of England, the general policy of statesmen, and in all countries commands a great deal of popular favour. It is, therefore, incumbent on the supporters of free-trade to account for this fact, and to indicate the reasons for the continued adherence to protection in most nations. The inquiry may, however, be best undertaken in a separate chapter.

[1] See above, pp. 105, 106; also Wicksell, *Finanztheoretische Untersuchungen*, pp. 65, 66, for this point.

CHAPTER IX

ARGUMENTS FOR PROTECTION—REASONS FOR ITS PREVALENCE

THE most plausible case which can be made for protection is in respect of newly-established industries, or in the commencement of a new stage of industrial development, as, *e.g.*, when a nation is reducing its export of raw produce and starting manufactures. In such a case it is argued that a duty on the import of foreign goods will allow the infant industries to gain maturity; otherwise they would be crushed out by the jealous competition of foreign rivals. They cannot, at first, manufacture as cheaply as the old and well-established producers of other nations, and they, therefore, require the fostering care of their national legislature to save them from extinction. It is further contended, that this method is the really economic one. Though, as the more reasonable advocates of the plan admit, there is an immediate loss, yet when the industries have been established, there will be a greater gain, which will more than recompense the nation for its earlier sacrifices. The imposition of duties for this purpose is represented as being analogous to the establishment of patents and

copyrights, and, in the case of individuals, the habit of apprenticeships.

It is hoped that the above argument has been correctly stated, as it appears in the hands of its ablest expounders; but it must be confessed that there is no little difficulty in getting a clear conception of the protectionist attitude on this, as on other points. In the foregoing statement the endeavour has been to give the strongest form of an argument, the importance of which has been fully recognised by Mill, as also by other economists.[1] At the outset, the possibility of the case must be granted. It is conceivable that a particular industry may, at first, be unprofitable, but may afterwards become very remunerative. The point at issue is, however, not one of mere possibilities, but rather the following:—Will the certain and immediate loss resulting from protection be outweighed by the future gains from the new industry? In making this estimate many matters have to be taken into account, which in the ordinary discussions on the subject are quite ignored. Among these are: the interest due to the nation on the wealth lost during protection; the determination of the right amount and proper period for the continuance of each duty; as well as the constitution of the body to which questions of such delicacy and complexity will have to be submitted, with the expectation of securing a sound judgment upon them. These conditions are, be it remembered, not mere theoretical refinements, but actual, practical problems, and they strongly impress us with the belief that this special case is in reality no exception to the

[1] For the history of the theory, see *The Commerce of Nations*, pp. 121, 133.

rule of freedom in international trade. Experience amply confirms this view. In the United States, and in the Australian Colonies, protectionists have urged the infant-industry argument in support of their claim, quoting the authority of J. S. Mill in their favour; but in both cases he has repudiated such an interpretation of his statement, and condemned the policy adopted.[1]

When we pass from the limited case of protection to one or a few industries to the wider problem of protection to a large body of producers—say manufacturers in general—the objections become very much stronger. If a duty be at first injurious in the case of a single industry, duties on all manufactures must be oppressive. If a nation does not possess manufactures —*i.e.* in the developed shape of factory-industries—all countries are more or less manufacturing in the older sense of the word—the very fact is conclusive proof that, economically speaking, it is better off without them. If there is no prospect in the most favourable circumstances of an industry yielding a suitable profit under a state of freedom, that industry, if artificially established, is not an element of strength, but of weakness. Here, again, experience gives support to the plain deduction which we have made. To take

[1] Referring to the often-quoted passage in his *Principles* (v. 10, § 1), Mill, in a letter to Mr. Horace White, writes the following:—"The passage has been made use of to show the inapplicability of free-trade to the United States, and for similar purpose in the Australian Colonies, erroneously in my opinion." See Laughlin's *Mill*, p. 614. For a further discussion of Mill's admission, see *Hermathena*, vol. vi. pp. 103, 104; and for an admirable historical inquiry into the effect of protection on American industries, see Professor Taussig's *Protection to Young Industries*, now included in his *Tariff History of the United States*.

the United States: it is a stock argument of American protectionists that without high duties their manufacturing industries would be destroyed[1]—an assertion which (if correct) does not speak much for the stimulating effect of thirty-five years of high protection. Like facts meet us all through industrial history. The weight of evidence is altogether in favour of the free-trader's contention, that productive power attains its greatest efficiency when it is directed by the normal economic motive of self-interest, which is more or less present in the case of every individual, and is thus more potent than the best-devised governmental arrangements. In maintaining this position it is not intended to deny that a Government may, by means of protection, introduce a new and profitable industry, or that various forms of production may be increased by the same method. Both these instances are quite consistent with the view here set forth, which declares that governmental interference, as regards the direction of industrial action, is, on the whole, more injurious than beneficial; as also that most industries, specially developed by the aid of protective duties, are rather a loss than a gain to the community in which they are established.

The arguments for protection are not based exclusively, or indeed mainly, on economic grounds. Many advocates of restrictive duties, while admitting their evil influence in the economic sphere, still maintain

[1] "To introduce the system proposed by the so-called revenue reformer is to break down our home-market in favour of Great Britain. It would close our mills and furnaces, and throw hundreds of thousands out of work."—Porter, *Protection and Free-Trade To-day*, p. 35.

that the gain in other respects is more than sufficient to compensate for this disadvantage. They regard the calculation of mercantile losses and gains as being of a mean and sordid character, unworthy of those to whom the destinies of a nation are entrusted. National well-being, they truly say, is preferable to national wealth; and it is on this broader ground that a protective system should be judged. To this general argument, which takes various special forms, some of them needing further investigation, the following answer may, perhaps, be sufficient:—The elements of national well-being are indeed various; and it is possible, and may sometimes be expedient, to increase one at the expense of another. There is, therefore, at first sight, nothing absurd in the proposal to sacrifice wealth for the sake of something else more desirable. Some would argue that of this point the economist, as such, is not entitled to judge, since his proper function ceases when he has investigated the economic aspects of the phenomena presented to him. But though economics is only one branch of social science, still it is connected with all the other branches, and its cultivators ought to be able, to some extent, to deal with the problems of general sociology. We may, then, legitimately consider those cases in which an opposition between wealth and well-being is alleged. Before doing so, we ought to notice one cause of error to be found in protectionist writings. In determining a practical question, non-economic considerations may prevail over economic ones; but that does not turn a mercantile loss into a gain. Where a sacrifice is incurred, it should be taken into account. It may, moreover, be said that, though economic reasons are

not necessarily decisive, they are in all instances important. Wealth is not as lofty an object as morality; but the possession of wealth is an aid to moral development: and without a certain standard of material comfort it is hopeless to expect great moral or intellectual improvement. There is good reason for the prominent place which wealth has obtained among the elements of national growth; though not identical with, it is an essential preliminary to the establishment of that higher social life for which reformers are striving. Any measure which aims at gaining advantage by an economic sacrifice has therefore to be supported by clear and cogent evidence before it can be accepted; and this presumption, strong in all cases, is increased in force as regards the protectionist plan, by its most obvious and apparent mode of action being directed to the economic conditions of society. Other proposals for State-intervention may correctly base their claims on higher grounds; but it aims at altering the course of exchange, while its alleged services in the promotion of a higher national development are, at all events, not at once visible. The difficulty of proving the claim is in its case much greater, and, until it is overcome, there is no necessity for minute examination of the numerous declamatory works of protectionist writers. This initial difficulty is, however, the very point which is neglected, its place being taken by vague and often self-contradictory assertions of the benefits to be obtained from the adoption of the restrictive system.

As we have said, there are some particular instances in which the plea for an economic sacrifice, in order

to attain a higher end, acquires greater force, and these must be briefly noticed:—(1) Certain restrictions on trade have been advocated on the ground of national safety. Such are: regulations forbidding the sale of arms to foreigners; the prohibition of aliens being employed on board ships belonging to the country in question; and the encouragement of the production at home of certain articles needed for war, instead of being dependent on foreigners for them. Perhaps the best-known instance of this class is to be found in the English Navigation Laws, which received the approval of Adam Smith and J. S. Mill.[1] The expediency of all measures of the kind depends on the probability of their attaining their object. When the success of the English Navigation Acts is brought forward, it is well to remember that similar enactments in France were failures;[2] a fact which goes to show that it was not legislation alone that promoted the development of the English navy. But it is certainly true that restrictive measures, though they may possibly help to create a naval force, are injurious in their influence when a large mercantile marine exists, as the wonderful expansion of English shipping since 1849 bears witness. Limitations on trade for the purpose of national defence should be the rare exception, and

[1] *Wealth of Nations*, p. 188*b*, and *Principles*, v. 10, § 1. It is not, however, quite certain that Adam Smith really approved of the maintenance in his time of the Navigation Laws. His remark that they are "perhaps the wisest of all the commercial regulations of England" does not necessarily imply that he thought them "wise," since he regarded the others as supremely foolish. Such a mode of expression is not unusual with him.

[2] See Stephen, *Lectures on the History of France*, vol. ii. pp. 297, 298.

should never be mixed up with a protectionist policy, as that is likely to cause their undue extension, under the pretence of solicitude for safety, when the real object is the shutting-out of foreign goods or labour.

(2) Agricultural industry has, in some cases, been regarded as entitled to special protection, either on the ground that a nation should not depend on foreigners for its food-supply, or that there is a peculiarly steadying and conservative influence exerted by the "agricultural interest," which needs and deserves the aid of the State. This argument was the nearest approach to reason in the position taken up by the supporters of the Corn Laws in England. The course of events has, however, shown that neither part of the contention was justified. The people of England are better supplied with food now than at any previous time in the present century; and the agricultural interest, using that term in its only natural sense, does not appear to have any monopoly of the virtues of conservatism—at least to such a degree as to make it advisable to levy a tax on the community at large for its supposed benefit.

The real effect of agricultural protection is, of course, as we saw before (pp. 136, 137), other things being equal, to raise rent: not at all to benefit either the labourer or farmer, though it is possible that it may increase the proportion of agricultural to non-agricultural workers, at the cost either of lowering the standard of comfort, or limiting the amount of the population, by the difficulty of procuring food. It will hardly be contended that either of these results will advance the power or well-being of a nation. It may, therefore, be concluded that the claim for protection to agriculture

is destitute of any justification, even when considered from a social rather than an economic point of view.

(3) The doctrine of agricultural protection is now somewhat discredited; but until a sound and scientific basis for policy has been obtained, the abandonment of one error usually makes way for another, perhaps less reasonable than its predecessor. So it has been in the present case. Protection to manufactures is now advocated on social grounds. Its supporters appear to believe that a high position cannot be gained by a nation without the possession of extensive manufacturing industries, which, therefore, are put forward as proper objects for the supervision and aid of a paternal Government. The reason for this strange belief is probably the great commercial and manufacturing supremacy of England. The increase of English industrial power has been concomitant with the growth of her manufactures, and the latter is regarded by superficial observers as the cause of the former. The natural result of such an idea is to induce other countries to encourage their manufactures by the use of protective duties, which will thus, it is believed, augment the national industrial forces. The chief advocates of this policy put forward a view of the history of industrial development which is so one-sided as to be utterly misleading. Thus, in List's survey of European commercial policy in the past, there is the underlying implication that English industry owed its success altogether to protection, and that English statesmen and producers aimed at destroying the manufactures of other countries, which in turn were justified in adopting similar expedients. The spirit of national animosity was, if not intention-

ally, at least directly encouraged by such a method.[1] In answer to this doctrine, it may be said that there is even less reason for encouraging manufactures than agriculture; the latter supplies the necessaries of life, the former only produces what is comparatively superfluous. Whatever may be the benefit to the State of a large agricultural population, it can hardly be urged that artisans are either physically or morally superior. If the State is to interfere at all with the deep-seated and subtle forces which direct the organisation and distribution of labour, there is surely no ground for its seeking to increase the mass of those urban populations, which in all countries present so grave a problem to the statesman and philanthropist. The evils which arise in a complex industrial society can be overcome by the maintenance of a high standard of comfort, combined with moral and intellectual training diffused among the great body of the population; but protection weakens this vital element of social prosperity by the economic losses which it inflicts on the society, as well as by the political spirit which it tends to create.

The argument for protection to manufactures sometimes takes the milder form of desiring to secure diversity of industry, in order to prevent a one-sided growth. Here, it ought to be evident that diversity of industry exists in even the most backward nations, as also that intelligence may be acquired in the profitable working of one complex industry, quite as well as in that of many smaller ones. The argument also overlooks the fact that production for a foreign market is in itself a

[1] See List, *National System* (Eng. Trans.), and the various works of H. C. Carey, for examples.

powerful exercise for the faculties. The moral and social advantages of international trade are in truth the strongest argument against any restriction on its operation. From the dawn of civilisation down to the present time, the trader has been the distributer of knowledge, as well as of commodities. The nations that have attained the highest place have not gained their position by exclusiveness, but by accepting frankly the material and intellectual productions of other countries.

It is not to a prohibitive policy only that the social argument for free-trade applies. All restriction, be it remembered, so far reduces the sum of foreign trade. It lowers the imports, and therefore necessarily the exports also. The effect reacts, more or less, on the whole economic system. We have seen (Chapter V.) how the entire series of transactions is linked together by the method in which exchange is carried on; and we have further noticed (p. 42) the great complexity of that series. Trade often takes what is at first sight an unaccountable direction; but, on examination, some special reason will appear for each seeming anomaly. A striking American instance is given in the following passage:—

"By the Act of 30th June 1864, the duty on imported bituminous coal was fixed at $1·25 per ton. By the Act of 1873 this duty was reduced to 75 cents per ton. A merchant of Boston, interested in the coal-mines of Nova Scotia, happening to be in Washington shortly after the change in the law, called on a prominent member of Congress who had been instrumental in effecting the reduction, with a view of expressing thanks to the latter for his action and vote. In the course of the conversation which ensued, it was incidentally mentioned that the Washington Capitol building itself was lighted with gas derived from the very Nova Scotia coal which had been

mainly affected and cheapened by the reduction of the duty in question. Some surprise being manifested by the Congress man that such should be the case, the merchant explained its happening in this wise: Small vessels sailed in the first instance, mainly from New England, to ports of the British North American Provinces, laden with miscellaneous freights—furniture, hardware, glass, coarse textiles and carpets, drugs, medicine, paper, machinery, etc.—the product of our domestic industries. These shipments, directly or indirectly, paid for Nova Scotia coal especially adapted to the economical manufacture of gas, which coal was then transported in American bottoms to the Potomac, and sold to the Washington Gas Company. A cargo being unloaded, the vessel was immediately reloaded with coal from the Cumberland mines of Maryland, especially desirable for blacksmithing or steam purposes, which coal was in turn transported and sold in the Boston market."[1]

This case, which is but one of a numerous class, shows the danger of imposing duties for any object except that of obtaining revenue, since it is almost impossible to lay down, *a priori*, the effects of any given interference. Thus protective duties in favour of the staple industries of a country, at first sight, seem simply useless. How, one asks in surprise, can American agriculturists be protected? It happens, however, that in the United States wheat is sometimes imported from Manitoba, potatoes from Nova Scotia, hams from Europe, and sugar from the West Indies.[2] In like manner, many special kinds of manufactured goods are imported into Great Britain, though, in the general result, the export of manufactures greatly preponderates over the import. In fact, not only are there many thousand commodities, but most of them are further subdivided into several distinct grades, some of which

[1] Wells, *Practical Economics*, p. 76, note 1.

[2] W. G. Sumner, *Argument and Evidence before the Tariff Commission*, pp. 17, 18.

may be imported and others exported at the same time. From this great and increasing specialisation of industries is derived one of the weightiest arguments against protection, since it is impossible for any State-agency to possess sufficient knowledge or flexibility, in order to frame proper regulations, and duly adjust them to suit alterations in the position of industry.[1]

The political evils of a protective system are also a serious item in the cumulative argument against it. The arrangement of the amounts of duty on the various industries degenerates into a struggle of the several interests involved—in fact, the competition of the market is transferred to the arena of the lobby. The influences thus brought to bear are peculiarly detrimental to a democratic form of government, as the condition of the United States Civil Service tends to prove. All the difficulties of representative institutions are increased by the adoption of protection, which diverts attention from the main issue of good government to the impossible task of pleasing the many incompatible interests, which seek encouragement and support.

The foregoing examination may relieve us from the task of considering the many fallacious pleas which are so frequently to be met with, more especially as they have been over and over again refuted. To any one acquainted with the true theory of international trade, the pleas of "one-sided free-trade," "the need of compensation for heavy taxation," "the competition of pauper labour," etc., will not seem very formidable.[2]

[1] Cp. Sumner, *Protectionism*, pp. 32, 33.

[2] For detailed discussion of the various protectionist arguments, see Fawcett, *Free Trade and Protection*, pp. 88-133; Sumner, *Protectionism*, pp. 114-155; Bastiat, "Sophismes Economiques," *Œuvres*, vol. iv. pp.

They are rather instructive, as illustrating the various modes in which sentiments and interests are able to re-clothe themselves when their former garments are worn out. We may, therefore, proceed to consider the general causes which support protectionism, and which may be best arranged in their natural order.

(1) First among the forces which give vitality to the system of restriction, the interested motives of special classes of producers should be mentioned. The history of American tariff-making affords many illustrations. Each group is seeking to get a high duty for its own product, while it wants to obtain at a cheap rate the raw material on which it works. The formation of the tariff of 1883 may be taken as a good example, and with respect to it the following passage from the work of an American historian will probably be sufficient evidence:—

"The history of tariff-making is not particularly honourable in all its details to any party or interest. It has too often partaken of a personal fight by manufacturers against the public and each other. The struggle on this occasion before Congress lasted nearly the whole session. It was earnest and sometimes bitter; some interests were satisfied with the final result, others were not. The attempt to modify the tariff brought into bold relief the numerous conflicting interests and the difficulty and delicacy of the undertaking. As our industries become more heterogeneous, the tariff also grows more complex, and the difficulty of doing justice to all is increased. For example, the wool manufacturers, to succeed best, must have free wool and dye-stuffs; on the other hand, both these interests desired protection. The manufacturers of the higher forms of iron must have free materials to succeed best; on the other hand, the ore producers, the pig-iron manufacturers, and every succeeding class desired a tariff on their products. It was not easy for these

1-126; Cherbuliez, *Précis*, vol. ii. pp. 64-79; Bastable, *Commerce of Nations*, pp. 133-156.

interests to agree, and some of them did not. The iron-ore producers desired a tariff of eighty-five cents a ton on ore; the steel-rail makers were opposed to the granting of more than fifty; the manufacturers of fence-wire were opposed to an increase of duty on wire-rods used for making wire, and favoured a reduction; the manufacturers of rods in this country were desirous of getting an increase; the manufacturers of floor oil-cloths desired a reduction or abolition of the duty on the articles used by them; the soap manufacturers desired the putting of caustic soda on the free list, which the American manufacturers of it opposed; some of the woollen manufacturers were desirous that protection should be granted to the manufacturers of dye-stuffs, and some were not; the manufacturers of tanned foreign goat and sheep skins desired the removal of the tariff on such skins; those who tanned them, and who were much less numerous, were equally tenacious in maintaining the tariff on the raw skins; and the same conflict arose between other interests."[1]

This passage, which forcibly illustrates the operation of interested parties in the establishment of protection, possesses the greater authority, as it is the admission of a protectionist, who regards the evils, which he is bound to narrate, as "merely blotches on the picture, and not the picture itself." In all countries "the interested sophistry of merchants and manufacturers"—to use Adam Smith's words—has been influential in establishing those restrictions which each particular section thinks likely to advance its own business without the slightest regard to the general advantage. It is impossible not to recognise the fact, that the action of organised bodies, employed in special industries, in working for their own immediate benefit, has been one—if not the greatest—force in establishing and maintaining protective systems.

[1] A. S. Bolles, *Financial History of the United States* (1861-1885) pp. 479, 480. See Sumner, *History of Protection in the United States* p. 43, for similar conflicts in forming the tariff of 1824.

(2) Though the active exertions of small classes of persons may exercise a great effect on legislation, it is impossible for them to preserve the vantage-ground that they have gained without the assistance of other favourable conditions, one of which is present in every community in the form of ignorance on all economic matters. Over a hundred years ago, the fallacies of the mercantile system were refuted in Adam Smith's great work; but before his time they had been exposed by many able writers without much result; and even at the present day, substantially similar doctrines are regarded as self-evident truths by the great bulk of every community. Side by side with the scientific doctrines of economists, a popular political economy still flourishes, which approves of "making work," of "spending money," of "employing native industry," and many similar fallacious ideas. It cannot, therefore, cause any surprise to find protection popular in the most liberal and enlightened countries, when we remember the various errors afloat in all classes of society on the simplest economic matters. Even amongst free-traders there is very often complete misconception as to the true basis of the policy that they support. Thus, it is sometimes believed that free-trade is only good when it, as is thought, produces an excess of imports over exports, or, again, that its advantage consists in securing the import of food and raw materials and the export of manufactures.

(3) Avarice and ignorance are not creditable sources from which to derive a policy; but protectionists may be consoled by the consideration of a third reason for the persistence of their creed, which has, in many countries, exercised a great power, viz.

the sentiment of nationality. The operation of this influence will best be seen by noticing the areas to which the system of restriction is to be applied. In every instance it will be found that the line of custom-houses is to be coincident with political boundaries. It is almost universally admitted, that within each nation freedom of exchange should exist. List and Carey themselves would repudiate the proposal to divide the several German principalities or American States by either revenue or protective duties; in fact, the former was the originator of the Zoll-Verein, which gave internal free-trade to Germany. The few exceptions really prove the rule. Most of the advocates of protection in Ireland look on that country as entitled to a separate national existence. In the English Colonies they look forward to separation, or hope to be included in a customs-league with the mother country, as some fair-traders propose. The growth of a protective sentiment has been connected with a feeling that the interests of each nation are opposed to those of all other nations. The writings of protectionists in every country aim at exciting that international bad feeling which has been the cause of so many evils. No matter how varied may be the conditions of industry, the same characteristic is apparent. In all cases those forms of production which are carried on at greater comparative cost have to be reduced or abandoned under the readjustments brought about by foreign trade. National sentiment is invoked to prevent this natural and beneficial change. Under the specious plea of supporting native labour, it undoubtedly gives support to the forces previously noticed.

The foregoing considerations seem to sufficiently explain the continued existence of a policy which is entirely opposed, not only to the conclusions derived from scientific investigation, but also to the healthy instincts of common sense. Error, however, does not cease to be error when its sources have been discovered; and therefore the whole system of restriction deserves nothing but censure and refutation. It is opposed to the most prominent tendency of recent years, which has been towards closer intercommunication and multiplication of exchanges, instead of the exclusiveness and separation either implicitly or explicitly advocated by protectionist writers.[1] We are, on this ground, particularly justified in expecting that for the future the development of international exchange will continue, owing not only to the improvement of economic knowledge, and the earnest endeavours of those who claim freedom of exchange as a natural right, but also to the influence of what has been finely called "Eternal Reason—the sum of conditions resulting from the laws of material growth."[2] Whatever be the course of events, the soundness and expediency of free-trade remain abundantly established, though it may be difficult to bring national policy into conformity with the results of reasoned theory.

[1] *E.g.* a lengthy work, which is written with a great parade of scientific knowledge, has for its concluding sentence the following:—"*The nearer we come to organising and conducting our* COMPETING *industries, as if we were the only nation on the planet, the more we shall make, and the more we shall have to divide among the workers.*"—Hoyt, *Protection versus Free Trade*, p. 435. The italics and capitals are in the original.

[2] Cp. Giffen, *Essays in Finance* (2nd series), pp. 273, 274; also Cournot, *Théorie des Richesses*, pp. 521, 522; and *Revue Sommaire*, p. 338.

CHAPTER X

CONCLUSION

THE general theory of international trade, as well as the conclusions thence derived, have been stated in the foregoing pages. This closing chapter may therefore most fitly be devoted to the examination of some points, which, though not actually part of the doctrines previously developed, are yet necessary for their correct apprehension in relation to the other parts of economic science. The importance of thoroughly understanding the affinities and proper place of each branch of a scientific system will be sufficient justification for the addition of this discussion.

Among these outlying questions, perhaps the most prominent is the effect of the transfer of the industrial agents from country to country. Though the economic definition of a nation (p. 3) seems to exclude the recognition of such a shifting, we have found that it is not only possible, but, in fact, frequent; and it may be well to see in what way the theory and its applications are thereby affected. There is one consideration which somewhat reduces the difficulty of examining this agency. In every society, the amount of each of the industrial factors is almost certainly in a process of continuous change, through the increase or decrease of

population, and of the sum of accumulated wealth; as also through the variations in consumption and the progress of invention. Thus the results produced by immigration do not, in essence, differ from those that follow a rapid increase of population; the influx of foreign capital resembles an acceleration in the speed of saving, and we may reasonably hold that the final result will not be very different in either case. In this way the international movements of labour and capital become assimilated to the ordinary processes of economic life, and may be regarded as the same in their general effect. What is really of interest for the present subject is rather the tendency towards equalisation of profits and wages, which is the consequence of complete mobility. It is beyond dispute, that the very large emigration of labourers from certain European countries to the United States has not so far lowered the rate of wages in the latter country, nor raised it in any of the former, as to produce even an approximation to equal rates of remuneration. This statement is still better founded for earlier periods. Emigration is, in truth, guided largely by other than purely economic motives—though at the present day the latter are gaining in comparative strength, and men are more anxious now than ever before to leave their country "for the sake of bettering themselves"—and, as a consequence, the distribution of population is not such as to secure the greatest efficiency in the production of wealth. As yet, therefore, the law of cost of production is not applicable to the values of imported commodities, and the ordinary economic theory of exchange needs modification before it can be used in explaining the facts of foreign trade. The power of

emigration does, however, to some extent, prevent any one nation from acquiring all the gains which it might otherwise obtain from its superior natural advantages. Where the difference between the rates of wages and profits in any two nations is considerable, there, as we have recognised (p. 9), a movement towards the country of greater productiveness will probably take place, and, through the operation of the law of diminishing return, its advantages will be reduced, while the inferior nation finds its position improved, since its population is so far reduced, and the least productive portions of its capital have been sent away.

It is instructive to compare the two processes by which the increased wealth arising from more efficient employment of the productive factors is divided. We saw (Chapter II.) that, by means of foreign trade, labour and capital were in each country distributed in such a way as to be employed only in the comparatively most productive industries in each country, all other wants being supplied by exchange, but that this did not cause the sacrifices on each side to be reduced to, or even tend towards, a common level. To take our hypothetical case (pp. 23 *sq.*), though A obtained x, and B obtained y on better terms, the amount of enjoyment realised depended in the last resort on the efficiency of A in producing y, and of B in producing x, on which fact foreign trade could not directly act. Migration of labour and capital, on the other hand, will probably affect this element, by enabling some labourers in the inferior country to obtain a share of the wealth of its neighbour, as also by allowing capitalists to invest in the more productive enterprises of the superior country. The relations of the United

States with European nations afford a good illustration of these statements. The gains of all classes in Europe have most certainly been raised by the investment of capital in America, and the relief which emigration has brought to the thickly-populated parts of the former Continent. It is well for us to qualify the conception of complete fixity, which exclusive attention to the theory of exchange would suggest, by a recognition of the other facts presented in the complex relations of nations.

In connection with the preceding question, a special point in the protectionist controversy, which could not be conveniently dealt with at an earlier time, may now be considered. Protectionists often claim for their scheme that it causes the immigration of labour and capital into their territory; and the same view has been taken by persons who deplore the emigration of English employers, caused, it is said, by the desire to get inside the tariff barriers of other countries. A modification of this belief is found in the assertion, that under free-trade population and capital would move towards the more fertile parts of the earth's surface, leaving the poorer countries desolate—an evil which is to be remedied by the aid of a protective system. To deal with this doctrine, it is only necessary to consider the causes of emigration. So far as they are non-economic, they may be disregarded, since an avowedly economic measure will not affect them. The economic motive for migration is the hope of gain, which can only be brought into operation by the existence of higher profits and wages in the duty-levying countries. Duties could, therefore, only draw capital and labour into a country which was superior in its

resources to that from which the labour and capital were drawn, and which would, all artificial conditions apart, have a tendency to attract those agents of production. The only possible way in which a protective duty could have the consequence attributed to it, is either by widening the margin between the rates of profit and wages in the two countries, or by affecting a special industry, whose main production was for export.[1] The chief field for the working of this force would be in the case of a large as against a small country.[2] For instance, it was often alleged in pre-Commonwealth days that Tasmania suffered from the protective policy of Victoria, which ought to have been its best customer. Swiss industry has also been affected by the tariffs of France and Germany, and were Ireland politically separate from England, some of its industries might, by means of protection in England, be transferred to that country. To recognise the possibility of a given case is one thing—to admit the expediency of creating it is quite another. In the present instance the evils of the supposed

[1] The case of the watchmakers' brought from Switzerland by Voltaire, which is used by Cournot (*Théorie des Richesses*, pp. 469-474), comes under this latter head. The tin-plate industry is also instructive. Under the influence of the tariffs of 1890 and 1897 this industry has been established and developed in the United States. Imports from South Wales have fallen to a low point. One result, however, has been the formation of a "trust," which has raised prices to consumers. Another is the growth of exports from South Wales to other countries. The effect of the cheaper production of both iron and steel has also to be taken into account. See Taussig, "The Iron Industry in the United States" (*Quarterly Journal of Economics*, vol. xiv. pp. 502-503).

[2] A small district might suffer greatly by the imposition of heavy duties on its trade with a large neighbouring country. The Isle of Wight, for example, might be ruined by a war of tariffs with England.

duties are evident. They lead to an artificial and uneconomic distribution of industrial forces, thus reducing the total amount of wealth; they inflict loss on the consumers of the commodities, whose place of production is to be altered, while they fail to allow for the natural effect of economic development in promoting the establishment of all profitable employments. It cannot be shown that France has profited by the efforts to transplant Swiss industries to its soil, nor that Switzerland has been much injured by such attempts. The general objections to a protective system apply in all their strength to this particular application of it.

The idea that freedom of trade may lead to depopulation rests on a confusion between two different branches of economic action, viz. the unrestricted exchange of commodities, which is all that free-trade prescribes, and the mobility of the industrial factors. The latter obviously depends on entirely different causes, and has little connection with the particular fiscal policy pursued. Germans emigrate in large numbers to America, Frenchmen prefer to remain at home, though both countries are protectionist in policy. In fact the probability is that where economic motives are the chief reason for emigration, protection will rather increase than diminish their force. Increased cost of living is not an inducement to the energetic and prudent to remain in a country, but that is precisely what protection tends to, and we may therefore assert that the fear of depopulation from free-trade is entirely devoid of practical foundation.[1]

The actual mode in which capital is transferred is

[1] Cp. for further discussion of this point Appendix C.

seldom correctly conceived. In dealing with this subject, writers seem to believe—or, at all events, they suggest the idea to the greater number of their readers—that the passage of certain documents, or, at the utmost, of bullion, is the form which the movement takes. The real course of events is thus obscured, and attention is fastened on the mechanism by which the transfer is accomplished, to the exclusion of the principal part of the phenomenon. In all cases it ought to be plain that capital is exported in the form of commodities, or that the borrowing country is enabled to retain certain articles which would otherwise have to be exported in discharge of its liabilities.

The relations of England with most new countries exemplify the foregoing statement. The enormous loans contracted on the London Stock Exchange by foreign states and companies are not complete when the bonds are issued. It is further necessary to send the value to the borrowing countries, which is done by the export of commodities capable of being used as capital by the importing nation. Iron and steel rails, for instance, formed a large item of English exports till within recent years. They enabled new railway lines to be speedily laid down, and increased the power of transport. Rolling-stock for railways was also taken in considerable quantities; and even services—in the shape of engineers and navvies—were procured for the same object. Articles suitable for directly aiding production are not, it must be added, the only mode in which capital can be exported. Commodities consumed by labourers constitute an important part of the total amount of capital, and the masses of ruder manufactures sent out some twenty-five years ago

by England show that a good deal of the value needed was exported in that manner.

The distinction drawn by some advocates of restrictive duties between raw material and finished products is, perhaps, due to a confused idea of the expediency of importing capital, as distinguished from articles of consumption; but the real nature of the phenomenon is very imperfectly understood by them, since it is impossible to say what articles may discharge the function of capital in any particular case.

It may now fairly be asked, What is the scientific and practical value of the doctrines which we have been engaged in considering? Is it not likely that economic and technical development will in no remote future render all the world one country, and what then will become of "international trade"? The answer is suggested by the general course which economic science has taken. A scientific doctrine is found to explain some given group of facts; if the subject-matter of the doctrine disappears, the explanation of course ceases to be of practical importance, but its scientific value does not therefore perish. Slavery, for instance, is an economic question which has for us little practical application; it does not therefore follow that the student can gain no benefit from a study of the admirable writings on the subject. They aid in interpreting historical events, and give models of sound research applied to questions beyond the reach of prejudice and party feeling. A like service may be done by the remarkable work of the English school on the question of foreign trade. The study of Ricardo, J. S. Mill, and Cairnes, will clear up many

difficulties in the course of economic growth, and will serve as a discipline to the inquirer.

But while asserting the permanent value of the theory in its scientific aspect, it is not intended to admit that its practical importance is likely to soon diminish. The causes which have established, and still maintain, different nations in the economic sense, are very deep-seated;[1] and as long as those bodies continue, there will be need for a doctrine of their relations. It is possible that new features will appear, and that some old ones will be lost—so much is to be found in all sciences which deal with a changing subject—but the essential aspects of the theory will for a considerable time remain intact. When new political and social forms, inconceivable at present, have been established, then it may be that an entirely new mode of treatment will be requisite in this as in other parts of economics, or even that there will be no pressing necessity for any treatment of a non-existent subject.

Whatever be the fate of the theory and its applications in the future, we may here emphasise our principal conclusion as to conduct. It is a negative one. Governments in their dealings with foreign trade should be guided by the much-vilified maxim of *laissez faire*. To avoid misinterpretation, let it be remembered that the precept rests on no theory of abstract right, or vague sentiment of cosmopolitanism, but on the well-founded belief that national interests are thereby advanced, and that even if we benefit others by an enlightened policy, we are ourselves richly rewarded.

[1] Cp. the remarks of Professor Flint, *Philosophy of History* (1893), pp. 26, 27.

APPENDIX A

HISTORY OF THE THEORY

THE theory of international trade has been developed in the way usual with scientific doctrines. It commenced in the shape of practical rules, which, however, necessarily implied a groundwork of theoretic conceptions. The earliest form of such doctrines, so far as can be gathered from the course of legislation (if that term may be applied to administrative regulations), advised the retention of specially useful commodities within the national territory, and amongst these money naturally obtained a chief place. The ruder application of this idea was called by Jones the "balance of bargains" system. It sought to regulate every exchange; and, in this way, to let no money whatsoever leave the country.[1] The more refined mercantile, or "balance of trade" theory, aimed at exporting more than was imported; thus keeping up a favourable balance, and, as it was supposed, causing an influx of money. The best-known English representative of this school was Thomas Mun, the author of *England's Treasure by Forraign Trade* (1664).[2] The English writers on commerce of the seventeenth century contained amongst their numbers some advocates of the highest form of empirical doctrine on the subject—the free-trade system. Of these, Dudley North,

[1] See the Essay on "The Primitive Political Economy of England" in Richard Jones's *Remains*, pp. 293-335.

[2] See the reprint issued by Harvard University in the series of *Economic Classics*, edited by Professor Ashley.

in his *Discourses of Trade* (1691), was the most remarkable. In his brief pamphlet we find the following profound remarks:—"That the whole world, as to trade, is but as one nation or people, and therein nations are as persons." "That a people cannot want money to serve the ordinary dealing, and more than enough they will not have." "That exchange and ready money are the same, nothing but carriage and re-carriage being saved." And it concludes with the sage reflection:—"Thus we may labour to hedge in the cuckoo, but in vain, for no people ever yet grew rich by policies; but it is peace, industry, and freedom that brings trade and wealth, and nothing else."[1] The anonymous writer of *Considerations on the East India Trade* also sets forth a sound commercial policy, and justifies it by logical arguments.[2]

A more advanced position was taken by Hume in his *Economical Essays* (1752). He points out the natural distribution of the precious metals, as well as the influence of the exchanges in maintaining equilibrium; and he almost reaches the conception that imports imply corresponding exports.[3] The effect of paper-money, and the supposed need for exporting surplus goods, are, however, erroneously treated. From Hume to his great contemporary Adam Smith is a natural transition; but we cannot say that there is any special contribution to the theory of foreign trade in the *Wealth of Nations*. His views on the real advantage of such trade are somewhat doubtfully

[1] The passages quoted above are samples of this most suggestive tract, which is to be found in *Select Tracts on Commerce* (edited by J. R. M'Culloch). The passages quoted are from pp. 513, 514, and 540.

[2] For an instructive account of the early English free-trade writers see Professor Ashley's valuable article, "The Tory Origin of Free Trade Policy," *Quarterly Journal of Economics*, July 1897, vol. xi. pp. 335-371.

[3] "Each new acre of vineyard planted in France, in order to supply England with wine, would make it requisite for the French to take the produce of an English acre sown in wheat or barley, in order to subsist themselves."—*Works* (ed. Green and Grose), iii. 336.

expressed, while his explanation of the division of gain between two trading countries[1] is plainly erroneous. Nor has he grasped the condition governing the international distribution of the precious metals. The qualities exhibited in that work by its illustrious author were, in truth, philosophic breadth of view, careful observation, and homeliness of illustration, rather than the analytic power so remarkably displayed by Ricardo, and which is essential in handling questions of currency and exchange.[2] Adam Smith, however, if he did not develop a definite theory, at least disposed for ever of the mercantilist doctrines, and thus left a clear field for a new and more positive construction.

His immediate followers made some valuable contributions, such as Foster's distinction between the balance of debt and the balance of trade,[3] which removes the basis of many errors; and Torrens' demonstration of the advantage of foreign trade, with his recognition of the division of the total gain among the two parties trading.[4] But the scientific theory of international trade must be credited to Ricardo. His pamphlets on the currency question prepared the way for the more general treatment, which is to be found in the seventh chapter of his *Principles*. The contents of that chapter are but the expansion and illustration of three cardinal propositions, which constitute his theory of foreign trade, and which run as follows:—(1) "No extension of foreign trade will immediately increase the amount of value in a country, although it will very powerfully contribute to increase the mass of commodities, and therefore the sum of enjoyments."[5] (2) "The same rule which regulates the relative value of commodities in one country does not regulate the relative value of the

[1] *Wealth of Nations*, p. 199.

[2] See for a more favourable judgment, Lorini, *La Moneta*, pp. 22 *sq.*

[3] *The Principle of Commercial Exchanges* (1804). Though Sir J. Steuart—as already mentioned (p. 74)—incidentally notices the distinction (*Works*, iii. 216), he completely fails to grasp its significance.

[4] *The Economists Refuted* (1808).

[5] *Works*, p. 72.

commodities exchanged between two or more countries."[1] (3) "The money of each country is apportioned to it in such quantities only as may be necessary to regulate a profitable trade of barter."[2] The elementary principles governing exchange between nations are here briefly but clearly indicated, though the form of statement will be found to need alteration and revision. The special questions of bounties on exportation and of colonial trade are dealt with in separate chapters, which are highly suggestive as to the general conditions affecting international exchange.

James Mill's *Elements* (3rd ed., 1821) gives a short statement of Ricardo's results, and improves their arrangement. Senior's *Lectures on the Cost of Obtaining Money* made the first step beyond Ricardo, though the conditions governing the value of money are not fully recognised by him, and the main point of Ricardo's doctrine is rejected. Still the connection of money wages with efficiency of work is an important contribution; and the true theory, as a whole, is almost stated in the assertion that "the portableness of the precious metals, and the universality of the demand for them, render the whole commercial world one country, in which bullion is the money, and the inhabitants of each nation form a distinct class of labourers."[3] The next advance in the theory was supplied by J. S. Mill in his discussion of the conditions determining international value;[4] and it may be said that he succeeded in getting the whole body of doctrines on the subject into a convenient form, though, as has been pointed out in the text, there are sundry gaps in the argument, and sometimes the inferences as to actual cases are unfounded. The views set forth in Colonel Torrens' *Budget*, though prior in publication, were not adopted as early as those of Mill; and the elements of truth contained in that work are mixed up with curious oversights,

[1] *Works*, p. 75. [2] *Ibid.* pp. 79, 80.

[3] *Three Lectures on the Cost of Obtaining Money*, p. 14.

[4] *Essays on Some Unsettled Questions of Political Economy*, pp. 1-46.

some of which were pointed out by Senior and Merivale in the controversy which arose on the various points involved. The third part of Cairnes's *Leading Principles* is devoted to a discussion of the whole subject of foreign trade. He seeks to modify Mill's results by a fuller recognition of the action of non-competing industrial groups in domestic trade, which to some extent affects the doctrine of comparative cost, and the rates of wages internationally considered. He further handles some topics insufficiently treated by Mill, such as the effect of indebtedness, and the connection of prices with the gain from foreign trade.

In later English works the views of Mill have been generally adopted with various modifications and minor differences. Thus Mr. Shadwell has objected to the part dealing with international values, and Mr. Sidgwick has taken a peculiar view of Mill's conception as to the basis of his theory. Professor Marshall has privately issued a mathematical study on the basis of the Ricardian doctrine, and Professor Edgeworth, in his masterly papers, while accepting Ricardo as "the founder of the theory," affirms that "Mill's exposition is still unsurpassed."[1]

The theory has had far less acceptance on the Continent. French writers in particular have regarded it as unduly subtle, and as unnecessarily abstract. Their opinion may be summed up in the judgment of M. Maurice Block:—"les économistes du continent ont bien fait de laisser 'la théorie du valeur international' de l'autre côté de la Manche."[2] A distinguished exception is, however, found in A. E. Cherbuliez, who has given an admirable summary, and though Cournot—who stands apart from the ordinary French school—is a hostile critic, he has devoted much attention to the subject.[3]

[1] *Economic Journal*, vol. iv. pp. 35-50, 424-443, 606-638; see especially pp. 606, 607.

[2] *Progrès de la Science économique*, vol. ii. p. 172.

[3] See, for further notice of French writers, the valuable introduction of Professor Sauvaire Jourdan to the French translation of this work.

Amongst German economists, Rau and Roscher have embodied parts of the theory in their text-books, but the most important discussion is that of Mangoldt, who has developed Mill's doctrines with decided acuteness.[1]

In Holland more notice has been given to Ricardo's theory, which has been expounded and criticised, especially in the work of Beaujon, entitled *Handel en Handelspolitiek* (1888).

Italian economists have also recognised the value of the work of the English school in respect to this subject. Cossa, Pantaleoni, Loria, Pareto, and Lorini may be mentioned as prominent contributors.

For the United States there is General Walker's ably popularised exposition in his *Political Economy* (edition of 1887), while Mr. Bowen[2] has sought, but without success, to utilise the theory in favour of protection. Professor Taussig's admirable studies apply its main features to the economic condition of the trade of the United States.[3]

[1] *Grundriss der Volkswirthschaftslehre*, pp. 203-250. See Professor Edgeworth's criticism, *Economic Journal*, vol. iv. pp. 630-636.

[2] *American Political Economy* (1st edition), chap. xxiv.

[3] *Tariff History of the United States*, and articles in the *Quarterly Journal of Economics* and *Economic Journal*.

APPENDIX B

ON SOME COUNTER-THEORIES OF INTERNATIONAL TRADE

THE statement of a theory gives sufficient opportunity for judging of its consistency; but it is possible for a series of propositions to be logically developed, and yet, owing to omissions in the premises, to fail in interpreting the phenomena to which it is applied. Moreover, a simpler explanation may be available, which will set aside more elaborate accounts; and therefore it will be well for us to examine any opposing theories on this subject of international trade. If it should appear that these various doctrines fail to elucidate some parts of the subject, or that they really seek to explain something different from the leading facts which have to be handled, then they, by their inherent weakness, will to some extent confirm the doctrines set forth by the great English economists.

Cournot.—The first theory that will claim our notice is that propounded by the distinguished French mathematician A. A. Cournot.[1] The prominence into which his name has been brought by the writings of Jevons and Walras, as well as the real merits of his work, entitle his doctrines to a careful examination; the more so, as Cournot has himself severely criticised the Ricardian theory of foreign trade. Those criticisms have been dealt with in the text, but the positive side of his system must now be considered. It consists in the suggestion, rather than

[1] *Théorie des Richesses* (Paris, 1863), Livre III. chaps. iv. v. vi.; cp. also his *Principes Mathématiques*, ch. x. xi. xii.; and his *Revue Sommaire*, pp. 204-213, 268-277.

precise statement, that a nation gains by exportation, and loses by importation. This surprising result is obtained by calculations based on certain assumed cases, which so far resemble the device employed by Mill in treating of international values. They, however, differ widely in another respect, viz. in the nature of the abstractions adopted. In Mill's exposition the broad facts of exchange are so simplified as to stand out clearly, and to admit of conclusions being drawn without the encumbrance of extraneous details; while in Cournot's cases, the complication is of a high degree, and the conclusion is vitiated by some serious errors; for:—(1) The conception of price is used throughout, notwithstanding that the value of money may vary from country to country—a course which of itself suffices to render any sound result unattainable. (2) In the chief instance on which the theory is worked out,[1] the law of diminishing return is operative, and on this exceptional, or at least particular, case, a general conclusion is formed. (3) The effect of foreign trade in causing a readjustment of productive power is passed over with a vague reference to his previous discussion on the conditions determining the growth of capital,[2] in which it is implied that the bare fact of demand is, in some cases, a sufficient reason for increased production. (4) A further error, which may indeed be regarded as the ground-idea of all his speculations on the subject, is to be found in the denial of the necessary connection between importation and exportation. It is at first assumed by him, and at a later stage of his inquiry expressly asserted, that a commodity can be exported with profit to the exporting country, while the commodities sent back in return are not supposed to yield profit to the country thus paying; so that, to use his own words, "the two markets are not symmetrically situated."[3] The calculations, therefore, rest on assumptions which are not only unreal, but also, in general, impossible; and they thus show the futility of handling

[1] *Théorie des Richesses* (Paris, 1863), Livre III. pp. 316-322.
[2] *Ibid.* chap. ii. [3] *Ibid.* p. 328; *Revue Sommaire*, p. 206.

such problems without the preliminary safeguard of examination into the essential conditions involved.

These very serious defects in Cournot's treatment of a topic with which his remarkable keenness and analytical power would seem to have peculiarly fitted him to deal, have naturally led to speculation as to the cause of his failure. Professor Edgeworth, who has effectively criticised Cournot's paradoxical results, attributes it "principally to the neglect of Consumers' Rent";[1] while Professor Irving Fisher ascribes it to a mathematical error resulting from "gross carelessness."[2] But the non-recognition of consumers' rent is only one, and that not the gravest, defect in Cournot's discussion. His mistake in a mathematical process might explain the results reached in the *Principes Mathématiques* of 1838, but could hardly account for the elaborate arguments in the *Théorie des Richesses*, published twenty-five years later, and prepared with knowledge of J. S. Mill's investigations. The most probable explanation appears to be that, notwithstanding all his intellectual vigour, Cournot was in this case influenced by a strong bias against the free-trade doctrine of Adam Smith and his followers, who were for him, as for List, "a school," and the advocates of "a system." His contemptuous treatment of one of the strongest arguments in the *Wealth of Nations* —the *Vin d'Écosse*, as he calls it—is a good illustration of this disposition. His protestations of impartiality referred to by Professor Fisher were probably sincere, but they do not alter the fact that, on passing into the region of foreign trade, "this superior intelligence, equipped with the most scientific apparatus, seems . . . to have taken a wholly wrong direction. He has not only committed errors in formal reasoning, but also has missed general conceptions appropriate to the subject."[3] A predisposition to accept conclusions that are universally admitted to be erroneous was, we cannot but think, the reason for this sudden fall.

[1] *Economic Journal*, vol. iv. p. 152.
[2] *Quarterly Journal of Economics*, vol. xii. pp. 129, 130.
[3] Edgeworth, *Economic Journal*, vol. iv. p. 625.

Henry Sidgwick.—Allusion has already been made, when treating of international values, to Sidgwick's doctrine on that subject; it will now be expedient to examine it more closely. Put briefly, it runs as follows:—The peculiar features of foreign trade are due to the fact of distance, which makes the process of exchange between different places a costly one; since there is the twofold expense of (*a*) sending commodities out, and (*b*) getting back other commodities in payment. The problem of international value consists in the determination of the conditions governing the division of this cost between the countries concerned.[1] It is at once evident that the question as thus stated is different from that discussed by J. S. Mill.[2] The latter seeks to determine the division of the total gain arising from foreign trade, and in so doing, considers the losses which are a diminution of that gain; while the theory under consideration deals only with one form of this diminution. It is therefore necessary for us to estimate the comparative worth of these theories in explaining economic phenomena; and here Mill's superiority can hardly be doubted. His investigation takes in everything treated of by Sidgwick, who, on the other hand, admits that he has furnished no solution of the division of gain in international trade.[3] Again, the position of money is not satisfactorily handled by Sidgwick. He states that it varies in value from country to country, owing to the existence of double cost of carriage; and to escape the resulting difficulty, he proposes the adoption of the conception of "real price," that is, price "estimated not in the actual money of either country, but by a standard of value common to the

[1] Sidgwick, *Principles of Political Economy*, book ii. chap. iii. pp. 202-216.

[2] *Principles*, book iii. chap. xviii.

[3] "It may be observed that the theoretical determination of the division of the expenses of Foreign Trade does not enable us to determine the total amount of the gain resulting from such trade to either nation."—*Principles*, p. 216.

countries, obtained by estimating and allowing for the differences in the value of actual money."[1] Here the effect of comparative intensity of demand on the terms of exchange is quite ignored; but so long as labour and capital are not mobile, this element cannot be neglected. It is, in truth, by placing in the background the fundamental fact of the difficulty of moving the factors of production from one nation to another, that Sidgwick's theory is essentially defective. His explanations would really apply far better to the case of exchanges between different places in the same country, where the conditions that he assumes are more nearly realised. Finally, his criticism of Mill can hardly be accepted. He tells us that Mill's "error appears to me most simply manifested in the earlier part of his argument, in which to exhibit most simply the 'elementary principle of International Values,' he omits the consideration of the cost of carriage; and supposes, for the sake of argument, that the carriage of commodities from one country to the other could be effected without labour and without cost. It is easy to show that, under the circumstances thus supposed, cost of production must determine the value of exported commodities, just as much as the value of commodities consumed where they are made; except we make the further hypothesis, rarely likely to be realised in fact, that, after the trade is established, there is no product *common* to the trading countries."[2] This contention passes over the fact that Mill expressly regards "the further hypothesis" as a necessary consequence of the non-existence of cost of carriage. "But for it," he says, "every commodity would be regularly imported or regularly exported. A country would make nothing for itself which it did not also make for other countries."[3] We have seen (pp. 29 and 35) that this statement is not correct; but the modification that we introduce gives no aid to Sidgwick's argument, since, where the law of diminishing return is in operation,

[1] *Principles*, p. 211.

[2] *Ibid.* p. 206.

[3] *Ibid.* iii. 18, § 3.

demand and cost of production act on each other—increased demand raising cost, and increased cost reducing demand.

Sidgwick, in the second edition of his *Principles*, replied "that this does not amount to saying that there would be no product common to any two trading countries if cost of carriage were non-existent, since two countries might still make the same thing for export to a third."[1] This admitted of the obvious answer, that, as the earlier part of Mill's exposition refers to the case of two countries cut off from the rest of the world, the supposition of these countries exporting a common product to a third country, *ex hypothesi* inaccessible, cannot be entertained. Professor Edgeworth, however, maintains the position which Sidgwick tacitly abandoned. He invokes the authority of Mangoldt in support of his proposition, that even under the unreal hypothesis of two countries with commodities produced at constant cost and cost of carriage altogether absent, there may be a commodity "produced in both countries, exported from one and imported into the other."[2]

In the distribution of industries between the two countries each will select those for the production of which it possesses a *relative* advantage; but it is possible, and in the case of countries with a great many products highly probable, that one commodity (x) will be on the margin between import and export. Then in respect to x, one country (A) will produce for the home market whatever the residue of its productive power will yield, and will obtain the needed surplus by importation from the other country (B). On the other hand, B will produce all of x that is required for home use, and will export the balance which is demanded by consumers in A. The natural objection that there is no profit to be made by this export is met by reference to the consideration that

[1] *Principles*, p. 206, note 1. For a discussion of the case of three countries see *Hermathena*, vol. vii. pp. 120, 121.

[2] *Economic Journal*, vol. iv. p. 620.

no extra profit is required, since cost of carriage being *nil*, producers in B are content with the profit of their home market. In fact, so far as *commercial* competition is concerned, the two countries have become one market with a common level of values. This important explanation gives nevertheless no support to Sidgwick's case against Mill (as, indeed, Professor Edgeworth fully recognises). For though there is an equalisation of values in the two countries, there is no tendency towards equal remuneration of sacrifices. *Industrial* competition is entirely absent. Hence the common commodity x is, or may be, produced at very different costs in the two countries A and B; so that the essential part of Mill's exposition holds good, though some of his incidental statements are inaccurate and require modification.[1]

Mr. Shadwell. — Mr. J. L. Shadwell, in his useful manual,[2] while accepting the main results of the Ricardian theory of international trade, takes exception to Mill's doctrine of international value on the ground "that he has not really explained the subject, but has merely re-stated the problem in a different way;[3] and that, in fact, the equation of international demand, far from being an important result, is simply a truism. This criticism is supported by the statement of what is claimed to be a more accurate explanation of the causes regulating international values. In an earlier part of his treatise Mr. Shadwell adopted a peculiar definition of value, as being

[1] Professor Edgeworth's valuable and courteous criticism of the error contained in the corresponding passage in the second edition of this work (see *Economic Journal*, vol. vii. pp. 398-400) has suggested the material for the more correct statement given above, and has, in addition, elucidated a specially difficult part of this complicated subject. The mistake of formally denying the possibility of a common product was the less excusable as its existence was recognised in the special case of a large country trading with a small one (*supra*, p. 43), as also in the case where productive power was limited (2nd edition, p. 182).

[2] *System of Political Economy* (London, 1877).

[3] Shadwell, p. 406.

"the esteem in which commodities are held as measured by the quantity of labour which will be given in exchange for them,"[1] and from this point of view he concludes that "to the question what determines the value of a foreign commodity, it may be answered, that it depends on three things: its cost of production, the difference between the efficiency of labour in the two countries, and the cost of carriage."[2]

It is impossible to accept either the critical or the constructive part of the doctrine just stated. Mill's theory does not consist merely in the statement of the equation of reciprocal demand, but in the indication of the forces which are in operation to produce that equation. Comparative intensity of demand will have an effect in determining the fluctuations of international values within the limits set by comparative cost. This real element in the problem is recognised by Mill. There is no place for it in Mr. Shadwell's account. Therefore, even granting that his conception of value is correct—though it is only a reassertion of the long abandoned doctrine of Adam Smith—still his theory is not complete, and consequently cannot survive in competition with Mill's wider and more thorough explanation.

[1] Shadwell, p. 105. [2] *Ibid.* p. 405.

APPENDIX C

ON SOME DISPUTED POINTS IN INTERNATIONAL TRADE

1. *The exposition of the theory of international values in terms of money*

ENGLISH economists, in dealing with the thorny subject of international values, have usually simplified their exposition by regarding foreign trade as being in form what it is in fact—the barter of commodities. This has been the method of J. S. Mill and Cairnes, as in later years of Professor Marshall and Professor Edgeworth.[1] Even Ricardo, who generally reasoned in terms of price, when approaching this special question in the famous seventh chapter of his *Principles*, employs units of labour.[2] The continental followers of the English school—Cherbuliez, Mangoldt, Beaujon—take the same course. On the other hand, Cournot, who has kept to prices all through his discussions, has, as we have seen (*supra*, pp. 173-75), fallen into serious errors.

Quite recently, however, Professor Nicholson, while holding generally to the position of Ricardo and Mill, has departed from the established mode of exposition, and

[1] See Professor Marshall's "Memorandum," supplied to the "Gold and Silver Commission," referred to *supra*, p. 60, note; and Professor Edgeworth's articles in *Economic Journal*, vol. iv.

[2] "Prices" are used in part of Fawcett's chapter on "Foreign Commerce" (*Manual*, book iii. chap. vii.), but this is in accordance with his treatment of domestic value, and further, has led to mistaken criticisms by such writers as Musgrave (*Studies in Political Economy*).

adopted by preference the procedure of Cournot, whose mistakes are, he thinks, not because, but "in spite of using money as a measure."[1] It thus becomes necessary to estimate the merits of the two methods, and to give reasons for the course pursued in Chapter II. of the present work.

At the outset, it is clear that either method, if followed with all the due precautions, and if no mistakes are made, should yield the same results as its competitor. "Relative prices must be adjusted to relative values."[2] Any discrepancy in conclusions is evidence of error somewhere.

Nor can it be denied that many parts of Professor Nicholson's exposition are of admirable force and lucidity. None the less do the reasons in favour of the older course appear convincing. For, in the first place, foreign trade in its ruder forms is actually barter. Regarded historically there can be no doubt that the use of a common measure of value arose gradually, and that the primitive forms of money were, essentially, prized commodities. Again, even in its modern form, foreign trade deals for the most part with *two* currencies, not with one. Trade between gold and silver standard countries is a prominent instance. We are not justified in assuming a single measure of value in such cases; each country has its own standard. But, thirdly, there is the variation in money value which is found between different countries. As pointed out in criticising Cournot (p. 174), the assumption of a general value of money is unfounded, and this Professor Nicholson would allow, though he does not appear to always bear it sufficiently in mind. One effect of the introduction of foreign trade is to alter the scales of prices in the countries thus brought into connection, so that the measure of value is changed in each country, but in different ways.[3]

[1] Nicholson, *Principles*, vol. ii. p. 270.

[2] *Ibid.* vol. ii. p. 299.

[3] Ricardo states this point effectively: "In the former part of this work we have assumed, for the purpose of argument, that money always continued of the same value; we are now endeavouring to show

To use money as a symbol of value under such circumstances can hardly fail to lead to complications that it is well to avoid. The facts that the precious metals in the countries of their production are not only money, but also profitable exports, and in any country may at times be so employed, afford an additional objection to the use of prices instead of the relations of commodities to illustrate the working of foreign trade. Thus in one of Professor Nicholson's cases we read, "assume that two countries, A and B, have the same standard and currency, and that the average rate of wages is 4s. per day in both countries before the trade is opened. Let each country produce both wheat and cloth, but . . . in A let one average day's labour make a yard of cloth or a bushel of wheat, whilst in B it takes two days to make a yard of cloth and a day and a half to make a bushel of wheat."[1] From this case a series of propositions as to the readjustments in production of wheat and cloth and in rates of wages in A and B under the action of foreign trade is developed. No notice, however, is taken of the fact that silver is a third commodity, and that in the given case it is the article in which B has the greatest relative advantage, while A's advantage is greatest in cloth.[2] Hence the trade will open with silver and cloth, not with wheat and cloth, as in Professor Nicholson's statement. Nor is this difficulty adequately met by

that, besides the ordinary variations in the value of money, and those which are common to the whole commercial world, there are also partial variations to which money is subject in particular countries, and the fact [*qu.* is] that the value of money is never the same in any two countries, depending, as it does, on relative taxation, on manufacturing skill, on the advantages of climate, natural productions, and many other causes."—*Works*, p. 81.

[1] Nicholson, *Principles*, book iii. chap. xxvii. § 5 (vol. ii. pp. 301, 302).

[2] Assuming that 4s. is the silver unit, we have a day's labour yielding in the two countries as follows :—

	Silver.	Wheat.	Cloth.
A	1	1	1
B	1	$\frac{2}{3}$	$\frac{1}{2}$

replying[1] that the assumption of the original rates of wages (4s. in each) is "an arbitrary" one, "made for simplicity." For it does in reality introduce an important element into the case, which does not receive proper consideration.[2] It is, moreover, noteworthy that Professor Nicholson finds it desirable to make use of all the other hypothetical simplifications adopted by Mill.[3] But if this be allowable, what scientific ground can there be for objecting to the one additional hypothesis, which is, besides, admittedly true in substance, viz., that the terms of exchange are the same as would exist if no money were used and trade were actually barter? It might even be contended that the particular hypothesis of barter has a much firmer foundation than those of (1) only two countries, (2) dealing in but two commodities, which (3) are produced at constant cost of labour and capital, (4) perfectly mobile within each country, but (5) unable to pass from one to the other country, while (6) there is no impediment to the movement of the commodities. All these assumptions, though admissible as logical devices, have yet an unreal appearance, which embarrasses the student, and they undoubtedly require very careful handling.

There thus seems to be no sufficient reason for complicating the problem of international value by introducing at the outset the elements of prices and money wages, which tend to distract attention from the essential points, and make detailed investigation more troublesome.[4]

[1] As Professor Nicholson does, *op. cit.* p. 302, note.

[2] It would be admissible to regard wages as paid in labour notes (as the Socialists propose). But then the labour notes in A would differ in value from those in B, and each would simply represent the commodities produced by the labour of the holders. Bargaining in labour notes between A and B would be, in fact, the very bartering of commodities observed in chap. ii. (*supra*, pp. 22-48).

[3] "And, to begin with, the same hypothetical conditions may be laid down as on the barter theory."—Nicholson, *Principles*, book iii. chap. xxvii. § 4.

[4] Some of the inquiries in book iii. chap. xxviii. of Professor

2. *On the effect of an improvement in production on foreign trade*

J. S. Mill has selected as a specially interesting case for the application of his theory the effect of an improvement in the production of an article in one of the two trading countries, and has discussed it (1) without using money, and then (2) by introducing a circulating medium.[1] By each method he reaches the same conclusion, viz., that the improvement may be more beneficial to the other country than to that in which it takes place. He does not, indeed, affirm that a country can be injured by an improvement in respect to the production of an article of export. The proportion of benefit may be altered to its disadvantage, but notwithstanding a benefit remains.

This more advanced position has been occupied by Professor Edgeworth, who argues that "the improvement may prove detrimental to the exporting country," and adds that "the proposition is sufficiently supported by common sense."[2] In dealing with the same problem by the aid of prices Professor Nicholson reaches a different result, and attributes the conclusion that the exporting country may be injured to the assumption that it does not consume the article in which the improvement has taken place, while it continues to devote the same amount of labour as before to its production.[3]

In this conflict of competent opinion it is desirable to reconsider the matter from the old standpoint. Let us

Nicholson's work may be referred to as examples of this complication. But it is also true that no better exercise for the student of economics could be devised than a careful comparison of the two methods in regard to the problems discussed in the chapter in question, and no more competent guide than Professor Nicholson could be found.

[1] See J. S. Mill, *Principles*, book iii. chap. xviii. § 5, and chap. xxi. § 2.

[2] *Economic Journal*, vol. iv. p. 40. Where the case of farmers gaining by a bad harvest is adduced as parallel.

[3] *Principles*, book iii. chap. xxvii. § 8; cp. also Edgeworth, *Economic Journal*, vol. ix. pp. 125-128.

suppose two countries A and B each producing the commodities x and y, A's unit of productive power yielding $10x$ or $20y$, B's unit $10x$ or $15y$. Under such conditions we may suppose that the ratio of exchange will be $10x : 16y$; then, so far as the particular units are concerned, A will have as the outcome of foreign trade $10x + 24y$, instead of $10x + 20y$, and B will have $10x + 16y$ instead of $10x + 15y$. A's demand is weaker than B's, and it gains the larger part of the advantage. Next let us follow Mill in assuming that A's productive power in respect to y increases by 50 per cent, then a unit of productive power will turn out $30y$; and let us further assume that B's demand for y is quite inelastic, so that the terms of exchange become not $10x : 16y$, but $10x : 29y$. B now gets the greater part of the gain from foreign trade, and the position will be that A has $10x + 31y$, B $10x + 29y$ (since $60y$ is the production of the two units in A). Still A is better off than before the improvement, or than it would be without foreign trade. If neither were in operation the total production would be $20x + 35y$; foreign trade would raise it to $40y$, the improvement without foreign trade would raise it to $45y$, $30y$ being confined to A's consumption, while a surplus amount of $15y$ may be attributed to the joint effect of both agencies. Under such conditions A cannot lose by the improvement. But another case is possible. Instead of an increase of 50 per cent, let us suppose that it is only 10 per cent. Then A's output of y per unit will be 22; further, it may be that as B's demand is inelastic the ratio will be $10x : 21y$. On these terms A will have $10x + 23y$, and B $10x + 21y$, so that B will have gained more than the improvement has given, and A will be somewhat injured. We are thus led to admit Professor Edgeworth's theoretical exception.

The difference between the two cases suggests a further point of interest. Where the gain from the improvement was greater than that from foreign trade, detriment to the country exporting the article now made cheaper was impossible. It is only where the benefit from im-

provement is smaller than the advantage of interchange that loss could result from it. Another circumstance to be remembered is that y is by the nature of the case an object of consumption in A, and that there is a gain of 10 per cent so far as that side of the matter is concerned. We have also attained this result by assuming a very peculiar condition of demand, viz., that in which B is a keen demander for a certain quantity of y, but a very feeble one for any additional amount. From $10x : 16y$ to $10x : 21y$ in consequence of a slight change in cost of production is an unusual movement. Still more important is the fact that in actual trade there are, not two countries and two commodities, but many countries and innumerable commodities. The demand of several countries would be more elastic than that of one, while, on the side of supply, the improvement would at first strengthen the position of the exporting country against its competitors. These considerations show that the fear of loss in such a case is not a matter for practical apprehension.

The real interest of the case lies rather in its indication of the relation between increased foreign trade and other improvements, and as showing how each works in the same direction and is essentially of the same kind, though conceivably one may in a special case affect the other.[1]

3. *On the possible loss of population and wealth through removal of restrictions on foreign trade* [2]

The late Professor Sidgwick has given the support of his high authority to the proposition that free-trade may lead to displacement of labour, and even maintains that a community may lose, not only population, but wealth, by the abandonment of protection. He puts forward as an

[1] For an instructive attempt to measure the comparative influence of removal of restrictions on trade and improvements in transport see Gladstone, "Free Trade, Railways, and the Growth of Commerce," *Nineteenth Century*, February 1880.

[2] See *supra*, pp. 160-162.

illustration what he very justly describes as "an extreme case," which may best be given in his own words:—

"Suppose a country (A) so thickly populated that additional agricultural produce could not be obtained from the soil except at a rapidly increasing expense, and suppose that one-third of its actual produce of this kind—say, for brevity, its corn—is now consumed by the persons engaged in its chief branches of manufacture. Suppose that the country, having been strictly protected, adopts free-trade, and that consequently the manufactures in question are obtained at half the price from another country (B) in exchange for corn; and for simplicity let us assume that the result of the fall in price is that the same *total* price is paid for the manufactures usually consumed. What, then, are the manufacturing labourers thrown out of work by the change to do? The course most obviously suggested by the circumstances is that they should emigrate and supply the labour required in the extended manufactures of B, or in the newly-developed trade between A and B. If they do not do this there seems no general ground for assuming that they will all be able to find employment in A as remunerative as that withdrawn from them. No doubt as the cost of production in agriculture may be assumed to increase continuously, a certain amount of additional labour may now be employed in agriculture which will be more productive on the whole than some of the labour employed before the trade was opened, the diminution in the amount of corn produced by each new labourer being more than balanced by the increased power of the corn to purchase manufactures. But if the additional labour is only applicable at a rapidly increasing cost, the point will very soon come at which this balance will be reversed, and it is theoretically quite possible that a portion of the labourers thrown out of manufacturing employment could not, in the present condition of industry, be employed in A in agriculture, so as to yield any surplus above their own consumption. And if they could not be profitably employed in agriculture, it is theoretically possible that they could not be so employed at all."[1]

The foregoing case suggests several points of interest. It is, as its propounder says, "an improbable one," since a

[1] *Principles*, pp. 497, 498.

country where the law of diminishing return operates so powerfully is far more likely to import than to export agricultural products. Still there are such countries—Ireland in the early part of this century was probably one—and there can be no doubt that under the assumed conditions foreign trade, leading to an extension of cultivation, may lower the return to agricultural industry, and so far injure the labouring class. Against this disadvantage we must set the addition to rent from the descent of the margin of cultivation, and the reduced cost of imported goods. The fact that by the opening of a foreign trade the country A exports food lends further plausibility to the contention that its population may thus be diminished. But these considerations are, it seems, disposed of by a closer investigation of the features of the case as stated above. The essential condition for international trade is a difference in comparative cost; but if the corn of country A so rapidly increases in cost as additional amounts are required, it seems plain that the difference in the costs of production of corn and manufactures in A and B will diminish and finally disappear, at which point, the utility of the trade ceasing, the trade itself will cease. Should the cost of producing corn still go on increasing, the state of things will be reversed, and A will export manufactures and import corn. Until the trade ceases there will be some gain or utility derived from it, though, as previously shown, particular classes may suffer. Another interesting point which is entirely unnoticed by Sidgwick is the probable effect produced by the previous "protection" on the population of country A. By it—assuming that the product of each labourer is the same in value—a tax of over 16 per cent has been levied on the population, *i.e.* manufactures form one-third of their expenditure, and are doubled in price, and levied too on articles of which they stand in need, since all the funds set free by the removal of the 100 per cent duty are devoted to buying the increased supplies of these very commodities. Therefore it cannot be doubted that were

labour able to move freely from A to B, the policy of protection would place a premium on the emigration of agricultural labour from A. Indeed, the case derives its plausibility principally from the tacit assumption that the introduction of free-trade also creates a previously non-existent mobility of labour and capital. Unless this assumption be made, we are forced to believe that the "protected" country A would suffer in population by a restrictive policy—except its resources were so far superior to country B, that cost of living in spite of "protection" would be lower than in B.[1] A further consequence, resulting from the supposed adoption of free-trade, which is not referred to in Sidgwick's discussion, is the effect produced on the agriculture of B. The opening of trade between A and B, if it displaces manufactures in the former, must so far displace agriculture in the latter. Even admitting that the manufacturers in A emigrate to B, the conditions of cost will be such as to make the export of agricultural produce to B profitable, and this produce will dislodge an equal amount of the produce of B, so that some of its agriculturists will be compelled to emigrate to A, and will find more advantageous employment in that country, *i.e.* until the rapidly increasing cost of production removes this advantage, when trade will cease.[2]

It therefore appears that, even in this "extreme" and improbable case, the effect of free-trade in reducing population cannot be established on theoretical grounds, while in practice no such illustration is to be found. Perhaps the condition of Ireland between 1825 and 1845 is the nearest approach to an actual illustration of the supposed case, since it exported food and imported other articles, with practicably complete free-trade in existence between it and Great Britain. Yet, during that period, its popu-

[1] In which case it would not lose population by the adoption of free-trade.

[2] Prof. Edgeworth (*Economic Journal*, vol. vii. p. 402) remarks that this "is not a very popular argument in favour of free-trade." The remark is true but irrelevant.

lation was rapidly increasing, and decline did not set in until the adoption of free-trade in corn by England removed Ireland's special advantage in the English market, and altered the nature of the commodities demanded.

In criticising the foregoing remarks Professor Edgeworth[1] has raised some points of such high importance for the true interpretation of the theory of foreign trade, that a brief consideration of them will probably be the best means for gaining additional light on the matter.

(1) To the objection urged above (p. 189), that Sidgwick's contention is inconsistent with the possibility of readjustment under the conditions of comparative cost, Professor Edgeworth rejoins: "I am unable to interpret the first objection consistently with my idea of the case. I had imagined a landed interest employing the portion of the agricultural produce not consumed by the owners and cultivators in the purchase of manufactures from a landless class. On the opening of trade the landed interest transfer their custom to the manufacturers in B, and the manufacturers in A are left to starve or emigrate." The obvious comment on this definite statement is, that it describes a conception of economic organisation very different from that adopted in the present work. In place of a landed and a landless class, it appears more in accordance with the conditions of the case to imagine a society composed of landlords, capitalists, and labourers, some of the two latter sections engaged in agriculture, others in manufactures. On the introduction of free-trade in A, which brings in cheaper manufactures, the manufacturers in A neither "starve" nor "emigrate"; they transfer their labour and capital to agriculture, in which there is, *ex hypothesi*, an opening, as food will be required for export to B in payment for the imported manufactures. Under the assumed conditions rent in A will rise, and so will the cost of agricultural production, until the point at which there is no difference in the comparative costs in the two countries is attained. At this point, again, the view of the situation taken in the

[1] *Economic Journal*, vol. vii. pp. 401, 402.

present work differs from that of Professor Edgeworth, for if, as has been stated above (p. 15), a difference in comparative cost is the essential condition for the maintenance of foreign trade, the absence of that condition involves the cessation of the trade[1] which is dependent on it. Otherwise, it would be impossible to understand how the export of agricultural products changes, as under a further development it would do, into the export of manufactures.

The passage in Torrens's *Production of Wealth* referred to by Professor Edgeworth tends to confirm the view taken above, for Torrens assumes that agriculture has reached its limit of production, and affords no field for additional capital. He thus avoids the difficulty that besets Sidgwick's case, though his hypothesis is, as Professor Edgeworth justly remarks, a "wooden" one.[2]

A second important matter is the influence of "friction." On the general principle there is happily agreement. But it is not altogether easy to see why the condition of friction should make it comparatively easy for artisans to migrate from A to B, but practically impossible for them to pass into agriculture in A, or for agricultural labourers to migrate from B to A. In dealing with such problems we may either leave friction out of account altogether, or consider it as it actually operates. It can hardly be admissible to specially assume the action of certain forms of friction to support an hypothesis in which the action of those particular forms has not been explicitly postulated.

This difficult question has been discussed since the appearance of the third edition of this book, by Professor Edgeworth, Professor Loria, and the present writer.[3] It

[1] This is certainly the doctrine of Ricardo, J. S. Mill, and Cairnes.

[2] It is worthy of note that Torrens's theory is really derived from the protectionist idea that home trade employs *two* capitals, foreign trade only *one*, on which see *The Commerce of Nations*, pp. 151, 152.

[3] See *Economic Journal*, vol. x. pp. 389-392; vol. xi. pp. 582-595 for Professor Edgeworth's reassertion of his position. Professor Loria (*Economic Journal*, vol. xi. pp. 87-89) strongly supports the view taken above. In the same volume, pp. 226-229, an attempt has been made to restate that view in reply to Professor Edgeworth's criticisms.

is desirable to indicate concisely the results obtained by further examination. First, it seems that Professor Edgeworth has somewhat misconceived the precise point at issue. He suggests that "the difference consists in Professor Bastable's taking a more abstract view of the conditions." "There would be no objection to his being content with the first and main approximation which postulates the solidarity of interests in a nation, provided that he did not complain of those who, proceeding to a second approximation, take account of the division of interests within a country."[1] This statement is a surprising one. No complaint of the kind was made. Indeed, one of the chief objects in the preparation of this book was to deal systematically with this very question of "the division of interests within a country." Chapter VI.—"The Influence of Foreign Trade on the Internal Distribution of Wealth"—is altogether devoted to this topic, and it contains a discussion of "the conceivable cases of loss" to particular classes, which is definite enough to have prevented any mistake as to the position taken up. The particular proposition of Sidgwick's which is under consideration is, "that a country may lose population through free-trade,"[2] and it was to that point that our criticisms were devoted. This discussion was in the second edition placed in Chapter X. in connection with the question of alleged depopulation through free-trade, and in the third edition a special reference to that chapter was given. It is hard to see what further precaution against misapprehension could have been taken.

Again, Professor Edgeworth remarks: "Enough has been said to show that . . . *the sudden introduction* of free-trade might reduce the working classes to beggary."[3] Though the statement is far too strongly worded to win

[1] *Economic Journal*, vol. xi. pp. 583-584.

[2] "So far we have not considered the effect of protection on the population of the two districts," is the phrase by which Professor Sidgwick commences his statement. *Political Economy* (1st ed.), p. 494.

[3] *Economic Journal*, vol. x. p. 392. The italics are ours.

assent, the important element of truth that it contains is not inconsistent with the position here taken.[1] For the point in dispute is not the temporary effect of a sudden change from one *régime* to another, but the permanent results of a free-trade policy. Nor does the fact that the labourers *may* lose, force us to the conclusion that they must straightway "starve or emigrate." Unless the standard of living is at the bare subsistence point, there is room for a fall in wages without reducing population.

On a third point it must still be maintained that there is a fundamental difference between the view taken in this book and that put forward by Professor Edgeworth, viz. On the relation of the several economic classes. In accordance with Ricardo's conception we have regarded society as made up of three classes—landlords, capitalists, and labourers, each marked off from the two remaining sections. It is this very social organisation which Professor Edgeworth asserts and repeats is the one contemplated by him,[2] but in his exposition the tripartite division is clearly replaced by one into two sections: (1) the possessors of land, and (2) the landless class. In his latest restatement the same idea reappears. "Let us break up the country which adopts free-trade into its constituent islands. Let that which is occupied by the working class be called a; and, *as we are not here much concerned with the gulfs which separate the other interests*, let us lump the rest of the archipelago under the designation a — comprising capitalist-entrepreneurs, possessors of land, owners of shares in productive

[1] The article in *Hermathena*, where the criticism on Sidgwick's view originally appeared, contained the following passage: "To avoid misinterpretation, I ought to add that a sudden and rapid change from a policy of strict protection to one of pure free-trade may cause considerable injury and loss—a proposition which is true of all great industrial changes — but I do not believe that free-traders, beginning with Adam Smith, have ever shut their eyes to the fact. If any have done so they have undoubtedly erred." Any such caution appeared to be unnecessary in a special work on foreign trade.

[2] *Economic Journal*, vol. x. p. 390; vol. xi. p. 586.

enterprises, and all manner of *rentiers*."[1] The clause which we have italicised brings out the essential difference between Professor Edgeworth's point of view and that which, following Ricardo, we have taken. In the Ricardian system the landowner and capitalist are sharply separated. They are "lumped" together by Professor Edgeworth. For the purpose of the present discussion the separation is important. When "additional agricultural produce cannot be obtained from the soil except at a rapidly increasing expense,"[2] increased demand benefits the landowner, but, by making capital at the margin less productive, it injures the capitalist. Thus the possible loss which is regarded by Sidgwick and Professor Edgeworth as falling on the labourer may be borne by the capitalist in reduced interest. Moreover, the difficulty of independent production on the labourer's part is obviated, for the capital to employ him is provided by the capitalists, and directing ability is furnished by the entrepreneurs, who are displaced from manufacturing industries. At this stage a question put by Professor Edgeworth in his latest treatment of the matter deserves consideration. "Why should the cost of agricultural products increase beyond the point at which it just pays entrepreneurs in A to exchange agricultural products for the manufactures of . . . B? and what reason is there for thinking that this point is so high that the cost of agricultural produce as compared with that of manufactured articles will be as great as it was in A before the opening of the trade?"[3] The answer which naturally occurs is that so long as there is unemployed labour and capital, there will be pressure which will reduce the returns obtained and continue doing so until the balance between agriculture and manufactures reaches the point at which import of manufactures ceases to be advantageous. When this point is attained, the labour and capital directed towards agriculture in consequence of the opening of

[1] *Economic Journal*, vol. xi. p. 587.
[2] Sidgwick, *l.c.* p. 497.
[3] *Economic Journal*, vol. xi. p. 588.

foreign trade, will be again employed in manufacturing for home consumption.

It thus appears that the industrial situation of A would be a fluctuating one—a section of its producers oscillating between agriculture and manufactures, which is an undesirable position. This, however, is merely the consequence of dealing with unreal abstractions. In considering Sidgwick's case we have endeavoured to regard it in the purely theoretical aspect. One essential point was that the condition of constant returns holds good in manufactures. From this assumption the instability, indicated above, results. If we admit that, *in certain respects*, manufactures come under the condition of diminishing returns, this difficulty is removed. We no longer have to deal with the complete abandonment of manufactures for agriculture, but rather with the contraction of the former and extension of the latter. Nor is there any trouble in seeing how, in fact, this influence is operative. Manufacturing is carried on by several producers possessing unequal advantages, and is, besides, composed of different industries which are not all on the same footing. This, it need hardly be said, is the actual condition in every country, but in discussing an avowedly hypothetical case which is simplified to the utmost we have to follow out the operation of the forces working under the given limitations. The result is, we believe, that stated in the preceding paragraph.

On another point—the real nature of the comparative cost which governs foreign trade—our difference from Professor Edgeworth is greater than he believes. While quite accepting the view that if the costs of production meant are the actual marginal costs established under the readjusting influence of foreign trade, there must be identity of cost; in both countries it was definitely stated that "for the special point under consideration that meaning appeared unsuitable."[1] Consequently, Professor Edgeworth's mathematical illustration and his further observations are altogether inapplicable. For the identical

[1] *Economic Journal*, vol. xi. p. 229.

comparative costs are merely the *result* of foreign trade: "the comparative costs which would exist at the margin on the hypothesis that each country is isolated" are the *causes* which determine the character and course of foreign trade. This is, we maintain, the right conception of comparative cost for the matter in hand. Professor Edgeworth's assertion of "complete agreement with Professor Loria" is also somewhat puzzling, as that distinguished writer is, and believes that he is, in agreement with the view we have taken. It is, however, accompanied by the important statement that the case of constant cost is excluded from the generalisation that the difference in cost disappears at the point of equilibrium. As this case is implied in Sidgwick's discussion, it becomes still more difficult to follow Professor Edgeworth's argument in its support.

Another point of difference which is of theoretical significance is that respecting the position of the labourers, who are regarded by Professor Edgeworth as dependent. Thus he writes: "The landed interest transfer their custom to the manufacturers in B, and the manufacturers in A are left to starve or emigrate."[1] And again, "supposing that a large body of workmen are thrown out of employment . . . and that only a small amount of food is allowed to them by the charity of the favoured classes."[2] The Ricardian point of view regards the labourers as independent producers, and therefore as not dependent on the "custom" of the landowners or in need of charity. This discussion of "so minute a point in so hypothetical a case" may, as Professor Edgeworth remarks, seem unnecessary, but he is fully justified in considering it as testing the more general theory, of which it need hardly be said he is a convinced adherent.

[1] *Economic Journal*, vol. vii. p. 401. [2] *Ibid.* vol. xi. p. 589.

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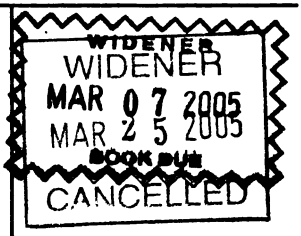

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